

**THE U.S. INTERNATIONAL TAX RULES:  
BACKGROUND, DATA, AND SELECTED ISSUES  
RELATING TO THE COMPETITIVENESS OF  
U.S.-BASED BUSINESS OPERATIONS**

Scheduled for a Public Hearing  
Before the  
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Prepared by the Staff  
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## INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing for July 8, 2003, on the effects of the U.S. international tax rules on the competitiveness of U.S.-based business operations. This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, provides general background and data relating to these rules, and specific discussions of the FSC-ETI controversy and certain base-erosion issues.

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<sup>1</sup> This document may be cited as follows: *Joint Committee on Taxation, The U.S. International Tax Rules: Background, Data, and Selected Issues Relating to the Competitiveness of U.S.-Based Business Operations* (JCX-67-03), July 3, 2003.

## **I. BACKGROUND: THE U.S. INTERNATIONAL TAX SYSTEM**

### **A. Tax Treatment of Foreign Activities of U.S. Persons**

#### **In general**

The United States employs a “worldwide” tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F<sup>2</sup> and the passive foreign investment company rules.<sup>3</sup> A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether earned directly by the domestic corporation, repatriated as an actual dividend, or included under one of the anti-deferral regimes.<sup>4</sup>

#### **Foreign tax credit**

The United States generally provides a credit for foreign income taxes paid or accrued.<sup>5</sup> In the case of foreign income taxes paid or accrued by a foreign subsidiary, a U.S. parent corporation is generally entitled to a “deemed paid” credit for such taxes when it receives an actual or deemed distribution of the underlying earnings from the foreign subsidiary.<sup>6</sup> The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer’s foreign-source income, in order to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting the U.S. tax on U.S.-source income.<sup>7</sup>

Due to this limitation, a taxpayer must allocate gross income and expenses between U.S. and foreign sources in order to determine the amount of allowable foreign tax credits. Under present law, interest expense that a U.S.-based multinational corporate group incurs in the United States is allocated to U.S. and foreign sources based on the gross assets located in the United

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<sup>2</sup> Secs. 951-964.

<sup>3</sup> Secs. 1291-1298.

<sup>4</sup> Secs. 901, 902, 960, 1291(g).

<sup>5</sup> Sec. 901.

<sup>6</sup> Secs. 902, 960.

<sup>7</sup> Secs. 901, 904.

States relative to those located abroad (measured either by basis or by fair market value).<sup>8</sup> Thus, a U.S.-based multinational with a significant portion of its assets overseas must allocate a significant portion of its U.S. interest expense to foreign-source income, which reduces the foreign tax credit limitation and thus the credits allowable (even though the interest expense incurred in the United States is not deductible in computing the actual tax liability under applicable foreign law).

The foreign tax credit limitation is applied separately to different types of foreign-source income, in order to reduce the extent to which excess foreign taxes paid in a high-tax foreign jurisdiction can be “cross-credited” against the residual U.S. tax on low-taxed foreign-source income. For example, if a taxpayer pays foreign tax at an effective rate of 45 percent on certain active income earned in a high-tax jurisdiction, and pays little or no foreign tax on certain passive income earned in a low-tax jurisdiction, then the earning of the untaxed (or low-taxed) passive income could expand the taxpayer’s ability to claim a credit for the otherwise uncreditable excess foreign taxes paid to the high-tax jurisdiction, by increasing the foreign tax credit limitation without increasing the amount of foreign taxes paid. This sort of cross-crediting is constrained by rules that require the computation of the foreign tax credit limitation on a category-by-category basis.<sup>9</sup> Thus, in the example above, the rules would place the passive income and the active income into separate limitation categories (or “baskets”), and the low-taxed passive income would not be allowed to increase the foreign tax credit limitation applicable to the credits arising from the high-taxed active income. Present law provides nine separate baskets as a general matter, and effectively many more in situations in which various special rules apply.<sup>10</sup>

If a taxpayer generates an overall foreign loss (“OFL”) for the year -- whether as the result of business losses or expense allocations under U.S. tax rules -- it will not be able to claim foreign tax credits for that year, since it will have no foreign-source income and thus will have a foreign tax credit limitation of zero. Moreover, if the taxpayer does generate foreign-source income in later years, some portion of such income will be “recaptured,” or recharacterized as U.S.-source, thus reducing the foreign tax credit limitation in later years.<sup>11</sup> The rationale for OFL recapture is that the foreign-source losses offset U.S.-source income in the year generated, thereby reducing the U.S. tax collected with respect to U.S.-source income. The U.S. fisc would not be made whole when the taxpayer subsequently earns foreign-source income if the U.S. taxes on such income were completely offset by foreign tax credits.

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<sup>8</sup> Sec. 864(e); Temp. Reg. sec. 1.861-11T.

<sup>9</sup> Sec. 904(d).

<sup>10</sup> *Id.*

<sup>11</sup> Sec. 904(f). These rules also operate on a category-by-category basis.

## Anti-deferral regimes

### In general

Generally, income earned indirectly by a domestic corporation through a foreign corporation is subject to U.S. tax only when the income is distributed to the domestic corporation, because corporations generally are treated as separate taxable persons for Federal tax purposes. However, this deferral of U.S. tax is limited by anti-deferral regimes that impose current U.S. tax on certain types of income earned by certain corporations, in order to prevent taxpayers from avoiding U.S. tax by shifting passive or other highly mobile income into low-tax jurisdictions. Deferral of U.S. tax is considered appropriate, on the other hand, with respect to most types of active business income earned abroad.

### Subpart F

Subpart F,<sup>12</sup> applicable to controlled foreign corporations and their shareholders, is the main anti-deferral regime of relevance to a U.S.-based multinational corporate group. A controlled foreign corporation generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only).<sup>13</sup> Under the subpart F rules, the United States generally taxes the U.S. 10-percent shareholders of a controlled foreign corporation on their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders.<sup>14</sup>

Subpart F income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another. Subpart F income consists of foreign base company income,<sup>15</sup> insurance income,<sup>16</sup> and certain income relating to international boycotts and other violations of public policy.<sup>17</sup> Foreign base company income consists of foreign personal holding company income, which includes passive income (e.g., dividends, interest, rents, and royalties), as well as a number of categories of non-passive income, including foreign base company sales income, foreign base company services income, foreign base company shipping income and foreign base company oil-related income.<sup>18</sup>

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<sup>12</sup> Secs. 951-964.

<sup>13</sup> Secs. 951(b), 957, 958.

<sup>14</sup> Sec. 951(a).

<sup>15</sup> Sec. 954.

<sup>16</sup> Sec. 953.

<sup>17</sup> Sec. 952(a)(3)-(5).

<sup>18</sup> Sec. 954.

In effect, the United States treats the U.S. 10-percent shareholders of a controlled foreign corporation as having received a current distribution out of the corporation's subpart F income. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are required to include currently in income for U.S. tax purposes their pro rata shares of the corporation's earnings invested in U.S. property.<sup>19</sup>

### Passive foreign investment companies

The Tax Reform Act of 1986 established an anti-deferral regime for passive foreign investment companies. A passive foreign investment company generally is defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income.<sup>20</sup> Alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a passive foreign investment company, regardless of their percentage ownership in the company. One set of rules applies to passive foreign investment companies that are “qualified electing funds,” under which electing U.S. shareholders currently include in gross income their respective shares of the company’s earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.<sup>21</sup> A second set of rules applies to passive foreign investment companies that are not qualified electing funds, under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest charge that is attributable to the value of deferral.<sup>22</sup> A third set of rules applies to passive foreign investment company stock that is marketable, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as “marking to market.”<sup>23</sup>

### Coordination

Detailed rules for coordination among the anti-deferral regimes are provided to prevent U.S. persons from being subject to U.S. tax on the same item of income under multiple regimes. For example, a corporation generally is not treated as a passive foreign investment company with respect to a particular shareholder if the corporation is also a controlled foreign corporation, and the shareholder is a “U.S. shareholder” as defined in section 951(b). Thus, subpart F is allowed to trump the passive foreign investment company rules.

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<sup>19</sup> Secs. 951(a)(1)(B), 956.

<sup>20</sup> Sec. 1297.

<sup>21</sup> Sec. 1293-1295.

<sup>22</sup> Sec. 1291.

<sup>23</sup> Sec. 1296.

## **B. Tax Treatment of U.S. Activities of Foreign Persons**

The United States asserts taxing jurisdiction over nonresident alien individuals and foreign corporations (“foreign persons”) only with respect to income that has a sufficient nexus to the United States. Foreign persons are subject to U.S. tax on income that is “effectively connected” with the conduct of a trade or business in the United States. Effectively connected income generally is taxed in the same manner and at the same rates as the income of a U.S. person.

Foreign persons are also subject to a gross-basis U.S. tax at a 30-percent rate on certain categories of non-effectively-connected income derived from U.S. sources (interest, dividends, rents, royalties, and other similar types of income), subject to a few exceptions. One major exception is that certain types of interest (for example, interest from certain bank deposits and from certain portfolio obligations) are not subject to the tax. The tax generally is collected by means of withholding by the person making the payment to the foreign person receiving the income.

## **C. Transfer Pricing**

Due to the variation in tax rates and tax systems among countries, a multinational enterprise, whether U.S.-based or foreign-based, may have an incentive to shift income, deductions, or tax credits among commonly controlled entities in order to arrive at a reduced overall tax burden. Such a shifting of items between commonly controlled entities could be accomplished by establishing artificial, non-arm’s-length (i.e., non-market) prices for transactions between group members.

Under section 482, the Secretary of the Treasury is authorized to redetermine the income of an entity subject to U.S. taxation when necessary to prevent an improper shifting of income between that entity and a commonly controlled entity. The statute generally does not prescribe any specific reallocation rules that must be followed, other than establishing the general standards of preventing tax evasion and clearly reflecting income. Treasury regulations adopt the concept of an arm's length standard as the method for determining whether reallocations are appropriate. Thus, the regulations generally attempt to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been uncontrolled parties dealing at arm's length. Special transfer pricing rules apply to transactions involving intangible property and services. These transactions present particular challenges to the administration of the arm’s length standard, since intangibles and services may be unique, thus rendering a comparison with third-party market transactions difficult or impossible.

## **D. Treaties**

In addition to the U.S. and foreign statutory rules for the taxation of foreign income of U.S. persons and U.S. income of foreign persons, bilateral income tax treaties limit the amount of income tax that may be imposed by one treaty partner on residents of the other treaty partner. For example, treaties often reduce or eliminate withholding taxes imposed by a treaty country on certain types of income (e.g., dividends, interest and royalties) paid to residents of the other treaty country. Treaties also contain provisions governing the creditability of taxes imposed by

the treaty country in which income was earned in computing the amount of tax owed to the other country by its residents with respect to such income. Treaties further provide procedures under which inconsistent positions taken by the treaty countries with respect to a single item of income or deduction may be mutually resolved by the two countries.

## II. BACKGROUND AND DATA RELATING TO INTERNATIONAL TRADE AND INVESTMENT

This part presents background data relating to the scope of the international trade sector in the United States economy. This part discusses the economic relationship between trade deficits, capital inflows, investment, and savings in the economy. It briefly reviews trends in both the current account (the trade surplus or deficit) and the financial account<sup>24</sup> (U.S. investment abroad and foreign investment in the United States). It also provides some evidence on the extent to which U.S. business have utilized FSCs and descriptive statistics of corporations that have utilized FSCs.

### A. Trade Deficits and Cross-Border Capital Flows

#### National income accounting

In popular discussion of trade issues, much attention is given to the trade deficit or surplus, that is, the difference between the exports and imports of the economy. In the late 1980s, there was also attention given to inflows of capital from abroad. Capital inflows can take the form of foreign purchases of domestic physical assets, of equity interests, or of debt instruments. These two phenomena, trade balances and capital inflows, are not independent, but are related to each other. Trade deficits, capital inflows, investment, savings, and income are all connected in the economy. The connection among these economic variables can be examined through the national income and product accounts, which measure the flow of goods and services and income in the economy.<sup>25</sup>

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<sup>24</sup> Prior to 1999, the U.S. Department of Commerce, Bureau of Economic Analysis reported and described international transactions by reference to the “current account” and the “capital account.” Beginning in June 1999 the Bureau of Economic Analysis adopted a three-group classification to make U.S. data reporting more closely aligned with international guidelines. The three groups are labeled: current account; capital account; and financial account. Under this regrouping, the “financial account” encompasses all transactions that used to fall into the old “capital account,” that is, the financial account measures U.S. investment abroad and foreign investment in the United States. Under the new system, the “current account” is redefined by removing a small part of the old measure of unilateral transfers and including it in the newly defined “capital account.” The newly defined capital account consists of capital transfers and the acquisition and disposal of non-produced, non-financial assets. For example, the newly defined capital account includes such transactions as forgiveness of foreign debt, migrants’ transfers of goods and financial assets when entering or leaving the country, transfers of title to fixed assets, and the acquisition and disposal of non-produced assets such as natural resource rights, patents, copyrights, and leases. In practice, the Bureau of Economic Analysis believes that newly defined “capital account” transactions will be small in comparison to the current account and financial account.

<sup>25</sup> The national income and product accounts measure the flow of goods and services (product) and income in the economy. The most commonly reported measure of national

The value of an economy's total output must be either consumed domestically (by private individuals and government), invested domestically, or exported abroad. If an economy consumes and invests more than it produces, it must be a net importer of goods and services. If the imports were all consumption goods, in order to pay for those imports, the country must either sell some of its assets or borrow from foreigners. If the imports were investment goods, foreign persons would own the investments. Thus, an economy that runs a trade deficit will also experience foreign capital inflows as foreign persons purchase domestic assets, make equity investments or lend funds (purchase debt instruments).

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economic income is gross domestic product (GDP). Related to GDP is gross national product (GNP). GNP is GDP plus the net factor income received by residents of United States from abroad. Thus, wages earned by a U.S. resident from temporary work abroad constitutes part of GNP but not GDP. Similarly, the returns from investment abroad constitute part of GNP but not GDP. To help understand the connection between trade deficits and cross border capital flows, in the following it is useful to use GNP, which includes cross border returns to investment, rather than the more commonly reported GDP concept. The GNP of the economy is the total annual value of goods and services produced by the economy and may be measured in several ways. One way to measure GNP is by expenditures on final product. By this measure,

$$(1) \text{ GNP} = C + I + G + (X-M) + \text{NI}.$$

Equation (1) is an accounting identity which states that gross national product equals the sum of private consumption expenditures (C), private investment expenditures on plant, equipment, inventory, and residential construction (I), government purchases of goods and services (G), net exports (exports less imports of goods and services and net interest payments to foreigners, or X-M), plus net investment income (the excess of investment income received from abroad over investment income sent abroad or NI).

An alternative is to measure GNP by the manner in which income is spent. By this measure,

$$(2) \text{ GNP} = C + S + T.$$

Equation (2) is another accounting identity which states that gross national product equals the sum of private consumption expenditures (C), saving by consumers and businesses (S), and net tax payments to the government (T) (net tax payments are total tax receipts less transfer, interest, and subsidy payments made by all levels of government).

Because both measures of GNP are simple accounting identities, the right hand side of equation (1) must equal the right hand side of equation (2). From this observation can be derived an additional national income accounting identity:

$$(3) I = S + (T - G) + (M - X) - \text{NI}$$

Equation (3) states that private investment equals private saving (S), plus public saving (T-G) and net imports (M - X), less net investment income.

For example, when the United States imports more than it exports, the United States pays for the imports with dollars. If foreigners are not buying goods with the dollars, then they will use the dollars to purchase U.S. assets. (An alternate way of viewing these relationships is that dollars flowing out of the U.S. economy in order to purchase goods or to service foreign debt must ultimately return to the economy as payment for exports or as capital inflows.)

The previous discussion focuses on the disposition of the economy's output. If the economy is a net importer, it must attract capital inflows to pay for those imports. If the economy is a net exporter, it must have capital outflows to dispose of the payments it receives for its exports. Another way of looking at the connection between capital flows and the goods and services in the economy is to concentrate on the sources of funds for investment. Because domestic investment must be financed either through saving or foreign borrowing, net capital inflows must also equal the difference between domestic investment and saving.

These relationships can be summarized as follows (the equation ignores relatively small unilateral transfers such as foreign aid and assumes, without loss of generality, that the government budget is balanced):

$$\begin{aligned}\text{Net Foreign Borrowing} &= \text{Investment} - \text{Saving} \\ &= (\text{Imports} - \text{Exports}) - \text{Net Investment Income}\end{aligned}$$

For this purpose, imports and exports include both goods and services, and net investment income is equal to the excess of investment income received from abroad over investment income sent abroad.<sup>26</sup> The excess of imports over exports is called the trade deficit in goods and services. Net investment income can be viewed as payments received on previously-acquired foreign assets (foreign investments) less payments made to service foreign debt.

If the investment in an economy is larger than that country's saving, the country must either be running a trade deficit or the economy is increasing its foreign borrowing. Similarly, a country cannot run a trade surplus without also exporting capital, either by increasing its foreign investments, or by servicing previously-acquired foreign debt. Because the level of net investment income in any year is fixed by the level of previous foreign investment (except for changes in interest rates), changes in investment or saving that are associated with capital inflows will have a negative impact on a country's trade balance.

### **Economic implications of trade deficits**

A trade deficit is not necessarily undesirable. What is important is the present and future consumption possibilities of the economy. That will depend in part on whether the trade deficit is financing consumption or investment. For example, if a country uncovers profitable investment opportunities, then it will be in that country's interest to obtain funds from abroad to

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<sup>26</sup> This equation in the text can be seen from equation (3) in footnote 14 above if the government budget is assumed to be balanced, that is, if  $G = T$ . It follows that if the government runs a deficit, that is, if  $G > T$ , for a given level of investment, saving, and net investment income, net foreign borrowing must be greater.

invest in these profitable projects.<sup>27</sup> If the economy currently does not have enough domestic savings to invest in these projects, it could reduce its consumption (generating more domestic saving) or look to foreign sources of funds (thus allowing investment without reducing current consumption). For example, suppose new oil reserves that could be profitably recovered through increased investment are discovered in the United States. The investment may be financed by foreigners. In order to invest in U.S. assets, foreigners will have to buy dollars, thus increasing the value of the dollar. This dollar appreciation makes U.S. goods more expensive to foreigners, thereby reducing their demand for U.S. exports. At the same time, the dollar appreciation makes foreign goods cheaper for U.S. residents, increasing the demand for imports and resulting in a trade deficit. Eventually, the flow of capital will be reversed, as the U.S. demand for new investment falls, and foreigners receive interest and dividend payments on their previous investments.

The foreign borrowing in the above example was used to finance investment. This borrowing did not reduce the living standards of current or future U.S. residents, because the interest and dividends that were paid to foreigners came from the return from the new investment. If foreign borrowing finances consumption instead of investment, there are no new assets created to generate a return that can support the borrowing. When the debt eventually is repaid, the repayments will come at the expense of future consumption. For instance, consider a situation in which the domestic supply of funds for investment decreases because domestic saving rates fall. Foreign borrowing in this case is not associated with increased investment, but instead is devoted to investment that was previously financed with domestic savings. Because the foreign borrowing is not associated with increased investment, future output does not increase, and interest and dividends on the investment will be paid to foreign persons at the expense of future domestic consumption. In this case, there may be an increase in the standard of living for current U.S. residents at the expense of a decrease in the standard of living of future residents.

During the period that foreign borrowing finances U.S. consumption, the United States runs a trade deficit. Although the United States could service its growing foreign debt by increased borrowing, and hence larger trade deficits, in the long run trade deficits cannot keep growing. In fact, the United States must eventually run a trade surplus. If the United States imported more goods than it exported every year, there also would be an inflow of foreign capital every year. This capital inflow would be growing with the increasing costs of servicing the foreign debt. Eventually, foreigners would be unwilling to continue lending to the United States, and the value of the dollar would fall. The fall in the dollar would eliminate the trade deficit, and the United States would eventually run a trade surplus, so that the current account deficit (the sum of the trade deficit in goods and services and the net interest on foreign obligations) would be small enough for foreigners to be willing to lend again to the United States.

Even when foreign investment finances domestic consumption, trade deficits and capital inflows themselves should not necessarily be viewed as undesirable, because the foreign capital

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<sup>27</sup> This scenario describes the experience of the United States in the mid to late 1800s, when foreign capital inflows financed much of the investment in railroads and other assets.

inflows help to keep domestic investment, and hence labor productivity, from falling. For instance, the large inflow of foreign capital to the United States in the 1980s is widely viewed to be a result of low U.S. saving rates. If the mobility of foreign capital had been restricted (through capital or import controls, for example), then the low saving rate could have led to higher domestic interest rates and lower rates of investment. That decreased investment would have led to decreases in future living standards because the lower growth rate of the capital stock would have resulted in lower growth rates of U.S. labor productivity. The fact that foreign capital was not restricted and did finance U.S. investment helped mitigate the negative effects on economic growth of low domestic saving.

The above observations support the argument that the trade deficit does not in itself provide a useful measure of international competitiveness, since trade deficits and trade surpluses can be either good or bad for the United States. The example of oil discovery discussed above shows that even increases in a country's stock of exportable goods can have ambiguous effects on the trade deficit. If the discovery of oil also increases the demand for investment, then the trade deficit may actually increase in the short run. Increases in natural resources, advances in technology, increases in worker efficiency, and other wealth-enhancing innovations have ambiguous effects on the trade deficit in the short and medium run. Because these innovations increase the productivity of U.S. workers and lower production costs, they increase the attractiveness of U.S. goods, and may result in increased exports. To the extent these innovations increase the demand for investment, however, they can have the opposite effect on the trade deficit. Nonetheless, each of these innovations increases the output of the economy, and hence the incomes of U.S. residents.

The balance of payments accounts, presented in Table 1, are analogous to a sources and uses of funds statement of the United States with the rest of the world. As demonstrated above, the current account balance, which consists primarily of the trade balance, should be exactly offset by the capital account and financial account balances, which measure the net inflow or outflow of capital to or from the United States. The difference between the current account surplus or deficit and the capital and financial accounts deficit or surplus is recorded as a statistical discrepancy. Problems of measurement, which have been large in some years, cause the accounts to be somewhat mismatched in practice, but basic patterns are unlikely to be significantly distorted by these problems. The subsequent sections examine trends in the current account and financial account in more detail.

**Table 1 – International Transactions of the United States, Selected Years,  
1975-2000  
(\$ Billions nominal)**

	<u>1975</u>	<u>1985</u>	<u>1995</u>	<u>2000</u>
<b>Current Account Balance</b>	<b>18.1</b>	<b>-118.2</b>	<b>-109.9</b>	<b>-444.7</b>
Exports of Goods and Services	<u>157.9</u>	<u>387.6</u>	<u>1,005.9</u>	<u>1,418.6</u>
Merchandise	107.1	215.9	575.2	772.2
Services	25.5	73.2	219.2	293.5
Receipts from U.S. assets abroad	25.4	98.5	211.5	352.9
Imports of Goods and Services	<u>132.7</u>	<u>483.8</u>	<u>1,081.8</u>	<u>1,809.1</u>
Merchandise	98.2	338.1	749.4	1,224.4
Services	22.0	72.9	141.4	217.0
Payments on foreign-owned U.S. assets	12.6	72.8	191.0	367.7
Unilateral Transfers	7.1	22.0	34.1	54.1
<b>Financial Account Balance</b>	<b>-22.5</b>	<b>101.3</b>	<b>113.3</b>	<b>443.2</b>
Foreign Investment in the United States	<u>17.2</u>	<u>146.1</u>	<u>465.7</u>	<u>1,024.2</u>
Direct Investment	2.6	19.7	57.8	287.7
Private non-direct investment	7.5	127.5	298.0	700.2
Official	7.0	-1.1	109.9	37.6
U.S. Investment Abroad	<u>39.7</u>	<u>44.8</u>	<u>352.4</u>	<u>581.0</u>
Direct Investment	14.2	18.9	98.8	152.4
Private non-direct investment	21.1	19.1	242.9	427.3
Increase in government assets	4.3	6.7	10.7	1.2
<b>Capital Account Transactions, net</b>	<b>n.a.</b>	<b>0.3</b>	<b>0.4</b>	<b>0.7</b>
<b>Statistical Discrepancy</b>	<b>4.4</b>	<b>16.5</b>	<b>3.8</b>	<b>0.7</b>

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Source: Douglas B. Weinberg, "U.S. International Transactions, First Quarter 2001," Survey of Current Business, 81, July 2001, pp. 37-81.

n.a. - not applicable

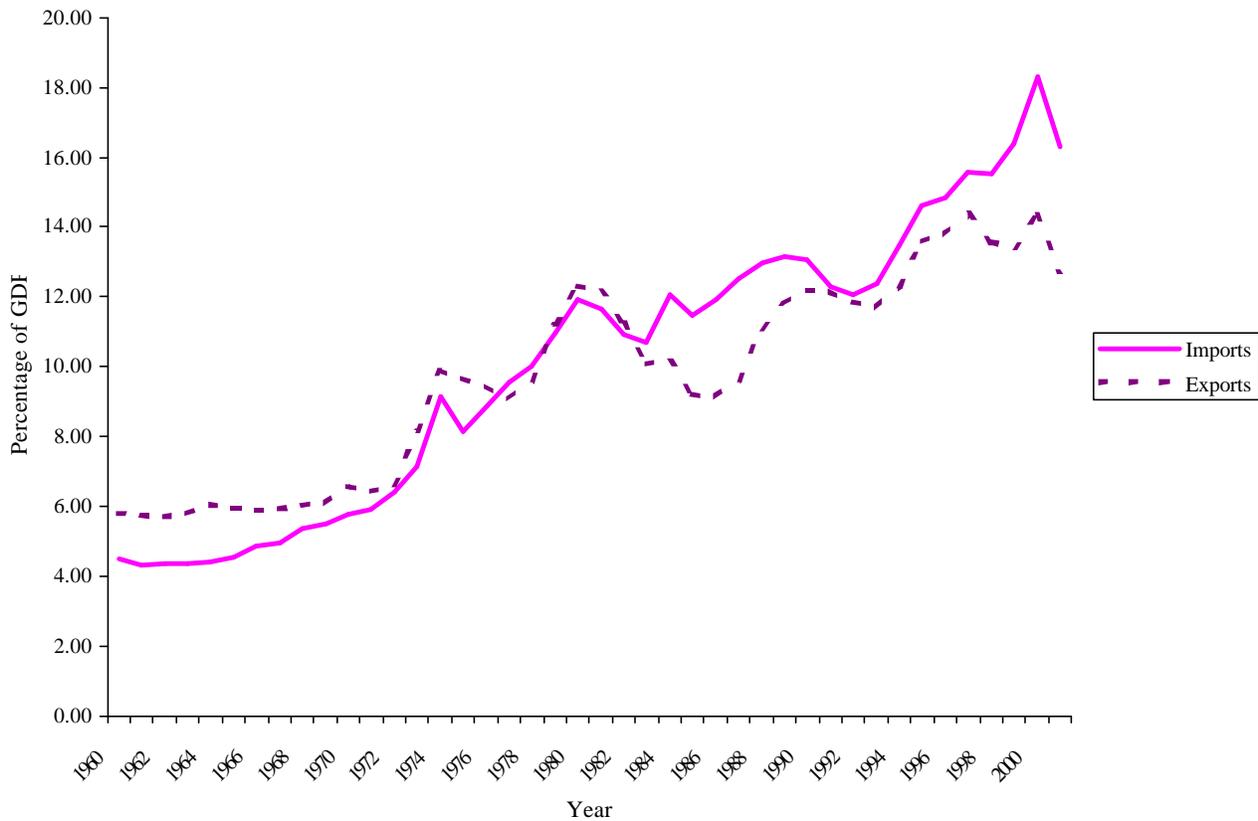
## B. Trends in the United States' Balance of Payments

### Overview of U.S. balance of payments (current account)

Foreign trade has become increasingly important to the United States economy. Figure 1 presents the value of exports from the United States and imports into the United States as a percentage of GDP for the period 1960-2001.<sup>28</sup> As depicted in Figure 1, exports and imports each have risen from less than six percent of GDP in 1960 to more than 12 percent in 2001. Figure 1 also shows that the United States generally was a net exporter of goods and services prior to 1982. Since that time, the United States has been a net importer of goods and services.

**Figure 1**

**Exports and Imports as a Percentage of United States GDP, 1960-2001**



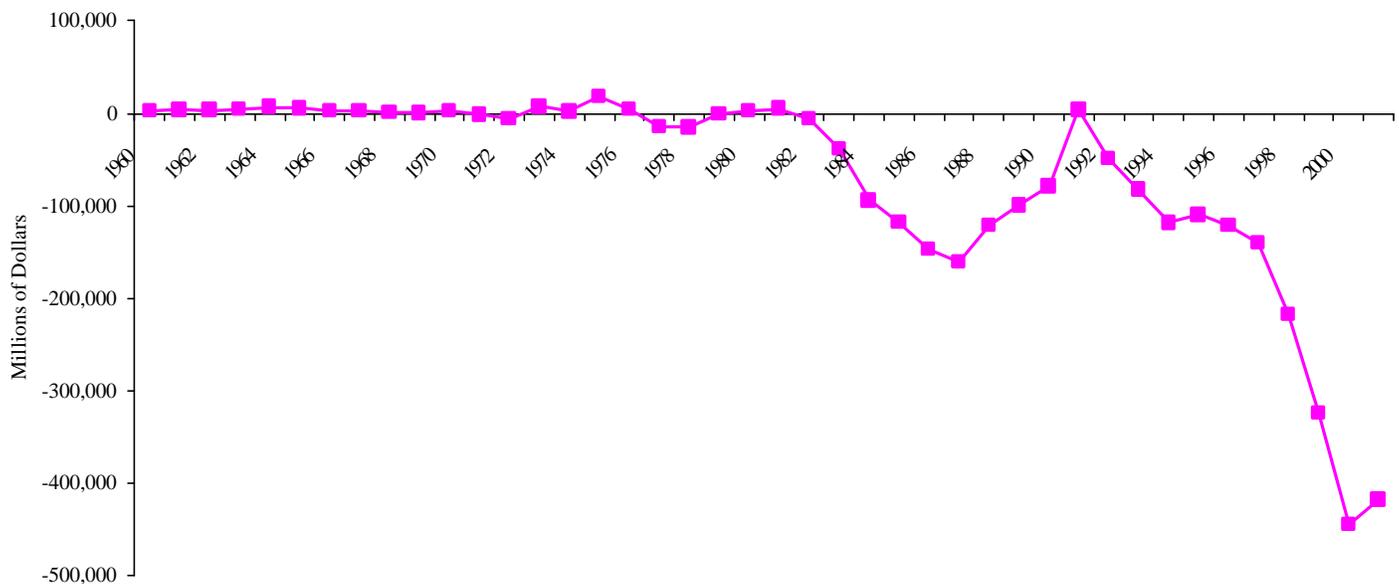
Source: Department of Commerce, Bureau of Economic Analysis.

<sup>28</sup> Data for Figure 1 are from the U.S. Commerce Department, Bureau of Economic Analysis and are reprinted in Appendix 1 and Appendix 2.

The net trade position of a country is commonly summarized by its current account. The U.S. current account as a whole, which compares exports of goods and services and income earned by U.S. persons on foreign investments to imports of goods and services and income earned by foreign persons on their investments in the United States (plus unilateral remittances), generally was positive from 1960 through 1981, but generally has been in deficit by over \$90 billion per year 13 times since 1984. Figure 2 reports the current account balance of the United States for the period 1960 through 2001 in nominal (non-inflation-adjusted) dollars.<sup>29</sup> Figure 3 presents the same data as a percentage of GDP to eliminate the effect of inflation on reported nominal figures. Figure 2 and Figure 3, like Figure 1, show the United States' change in status from net exporter to net importer since the early 1980s. Figure 2 and Figure 3 reflect a substantial reduction in the current account deficit for 1992. In that year, the United States received substantial payments from abroad related to the Persian Gulf War.

**Figure 2**

**United States Current Account Balance, 1960-2001**  
[millions nominal dollars]

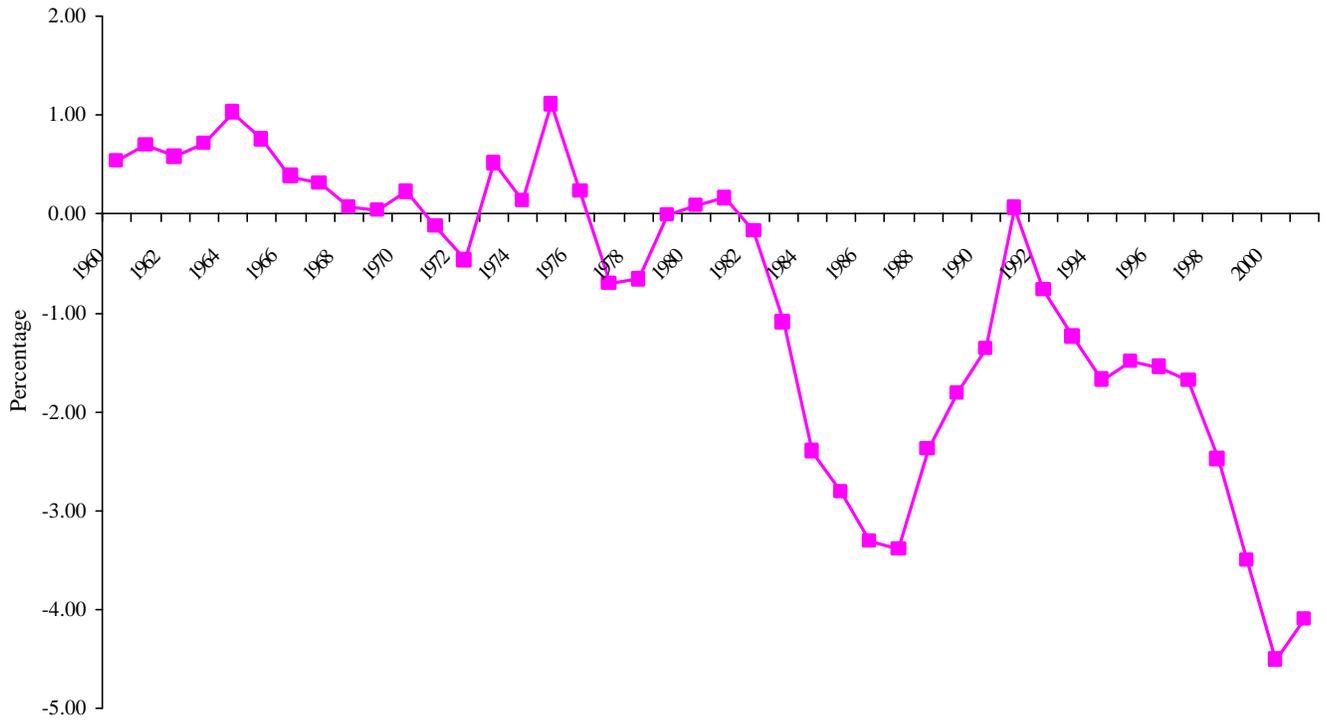


Source: Department of Commerce, Bureau of Economic Analysis.

<sup>29</sup> Data for Figure 2 and Figure 3 are from the U.S. Commerce Department, Bureau of Economic Analysis and are reprinted in Appendix 1.

**Figure 3**

**United States Current Account Balance as a Percentage of GDP, 1960-2001  
(percent)**



Source: Department of Commerce, Bureau of Economic Analysis.

## **Components of the current account**

### Merchandise trade, trade in services, and income from investments

The aggregate data reported in Figure 1, Figure 2, and Figure 3 mask differences in the trade position of various sectors of the economy. As explained above, the current account compares exports of goods and services and payments of income earned by U.S. persons on foreign investments to imports of goods and services and payments of income earned by foreign persons on their investments in the United States. Figure 4 and Figure 5 separately chart the nominal dollar value of exported and imported goods referred to as “merchandise trade” (Figure 4) and merchandise trade as a percentage of GDP (Figure 5). Figure 6 and Figure 7 separately chart exported and imported services in nominal dollars and as a percentage of GDP. Figure 8 and Figure 9 separately chart investment income earned by U.S. and foreign persons in nominal dollars and as a percentage of GDP.<sup>30</sup> The sum of the export curves in, Figure 4, Figure 5, Figure 6, Figure 7, Figure 8, and Figure 9 less the sum of the import curves (plus unilateral remittances) equals the current account balance curves of Figure 2 and Figure 3.

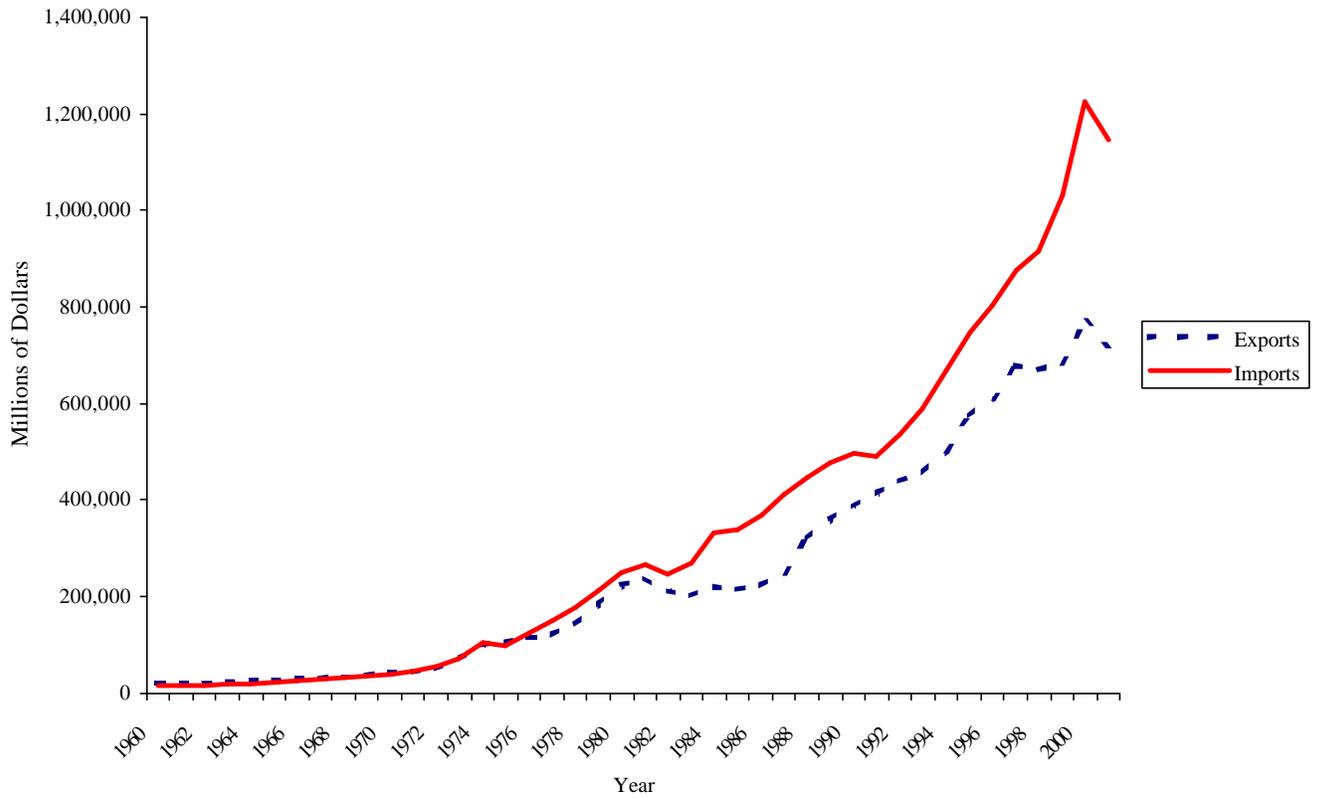
Figure 4, Figure 5, Figure 6, Figure 7, Figure 8, and Figure 9 reveal different trends. As has been widely reported, the merchandise (goods only) trade deficit has been over \$100 billion per year since 1984 and over \$500 billion per year since 1996. On the other hand, the United States has been a net exporter of services since the mid-1970s (Figure 6 and Figure 7). Only since 1998 have payments of income to foreign persons on their U.S. investments exceeded U.S. receipts of income on investments abroad (Figure 8 and Figure 9).

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<sup>30</sup> Data for Figure 4, Figure 5, Figure 6, Figure 7, Figure 8, and Figure 9 are from the U.S. Commerce Department, Bureau of Economic Analysis and are reprinted in Appendix 1.

**Figure 4**

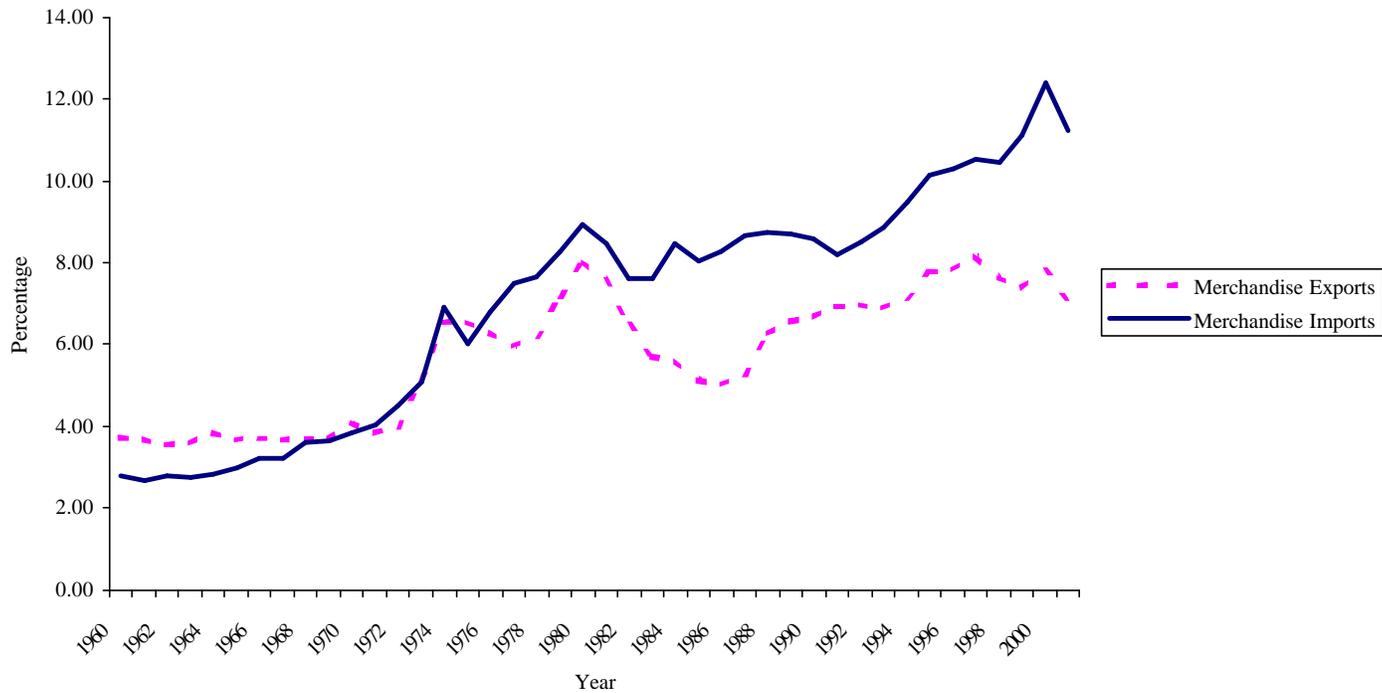
**U.S. Merchandise Trade, 1960-2001**  
[millions nominal dollars]



Source: Department of Commerce, Department of Economic Analysis.

**Figure 5**

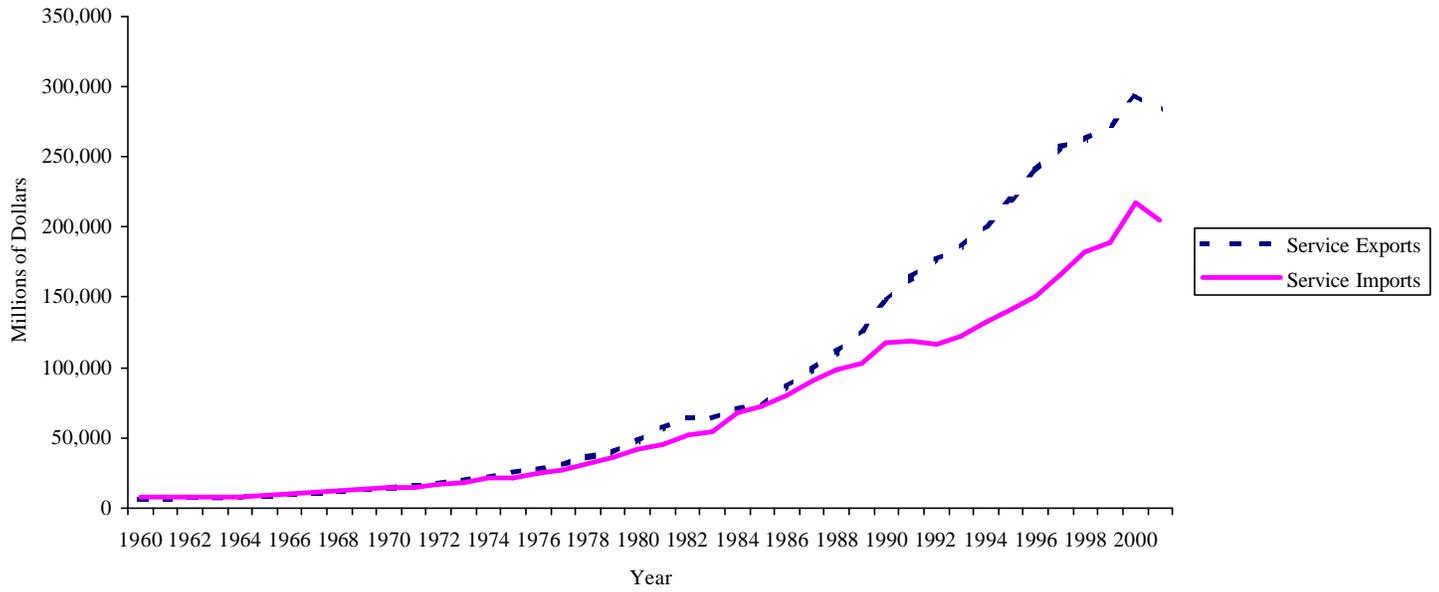
**U.S. Merchandise Trade as a Percentage of GDP, 1960-2001  
(percent)**



Source: Department of Commerce, Bureau of Economic Analysis.

**Figure 6**

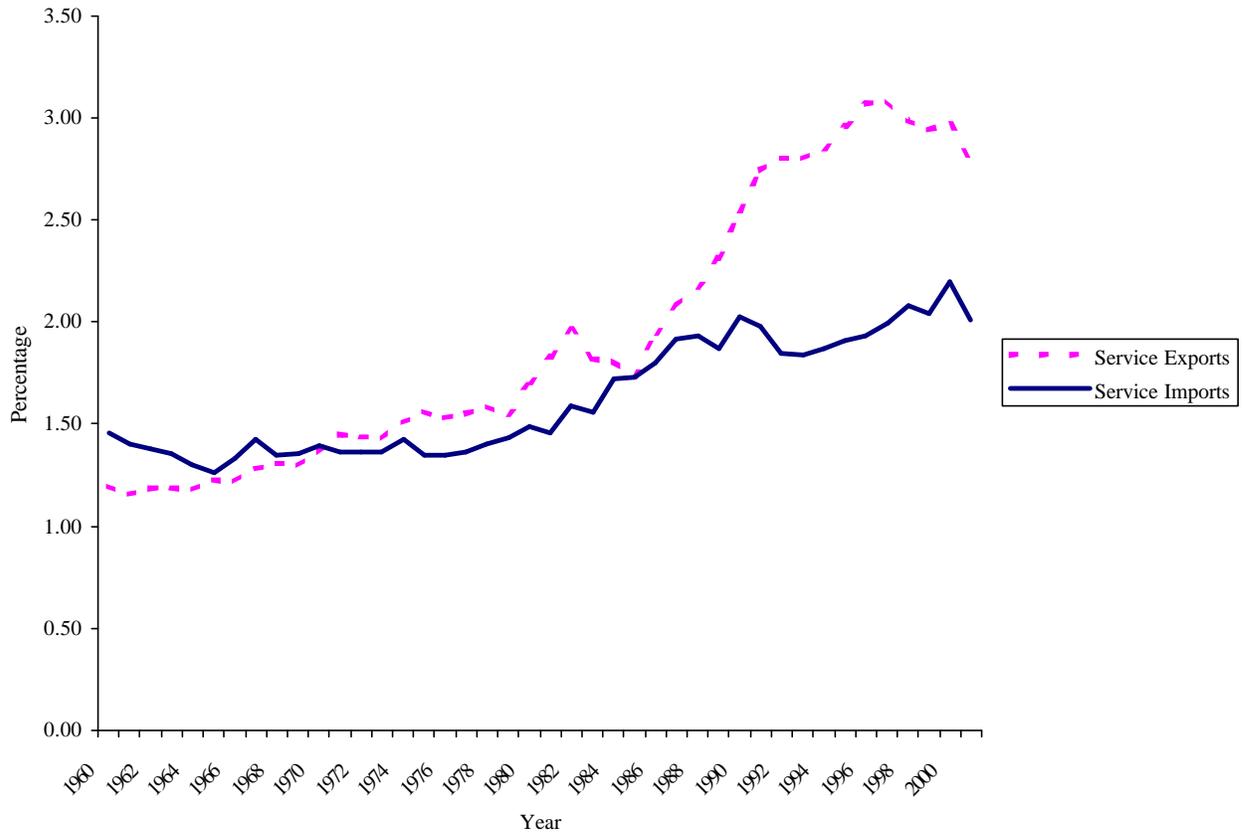
**Trade in Services, 1960-2001**  
[millions nominal dollars]



Source: Department of Commerce, Bureau of Economic Analysis.

**Figure 7**

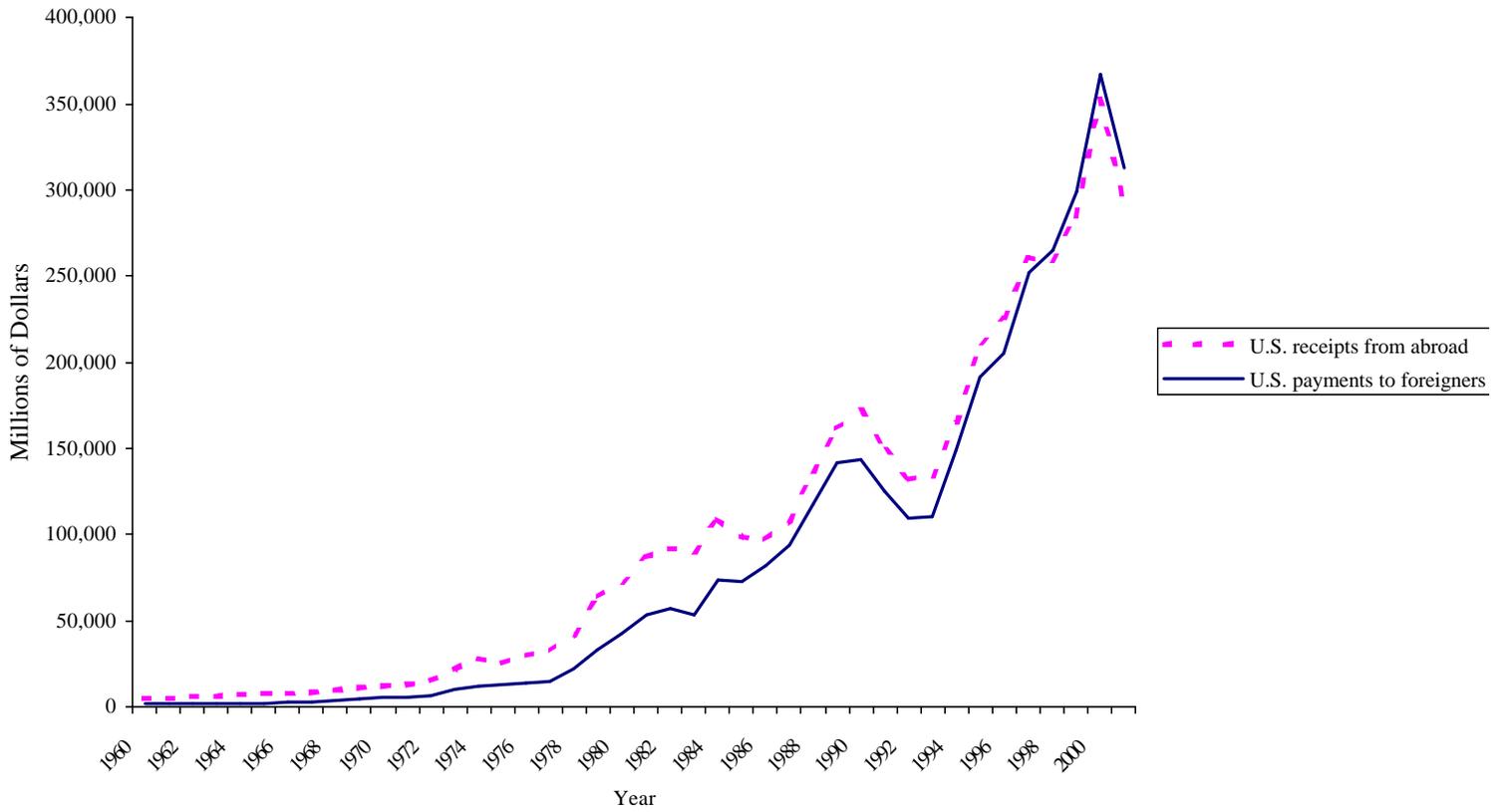
**Trade in Services as a Percentage of GDP, 1960-2001  
(percent)**



Source: Department of Commerce, Bureau of Economic Analysis.

**Figure 8**

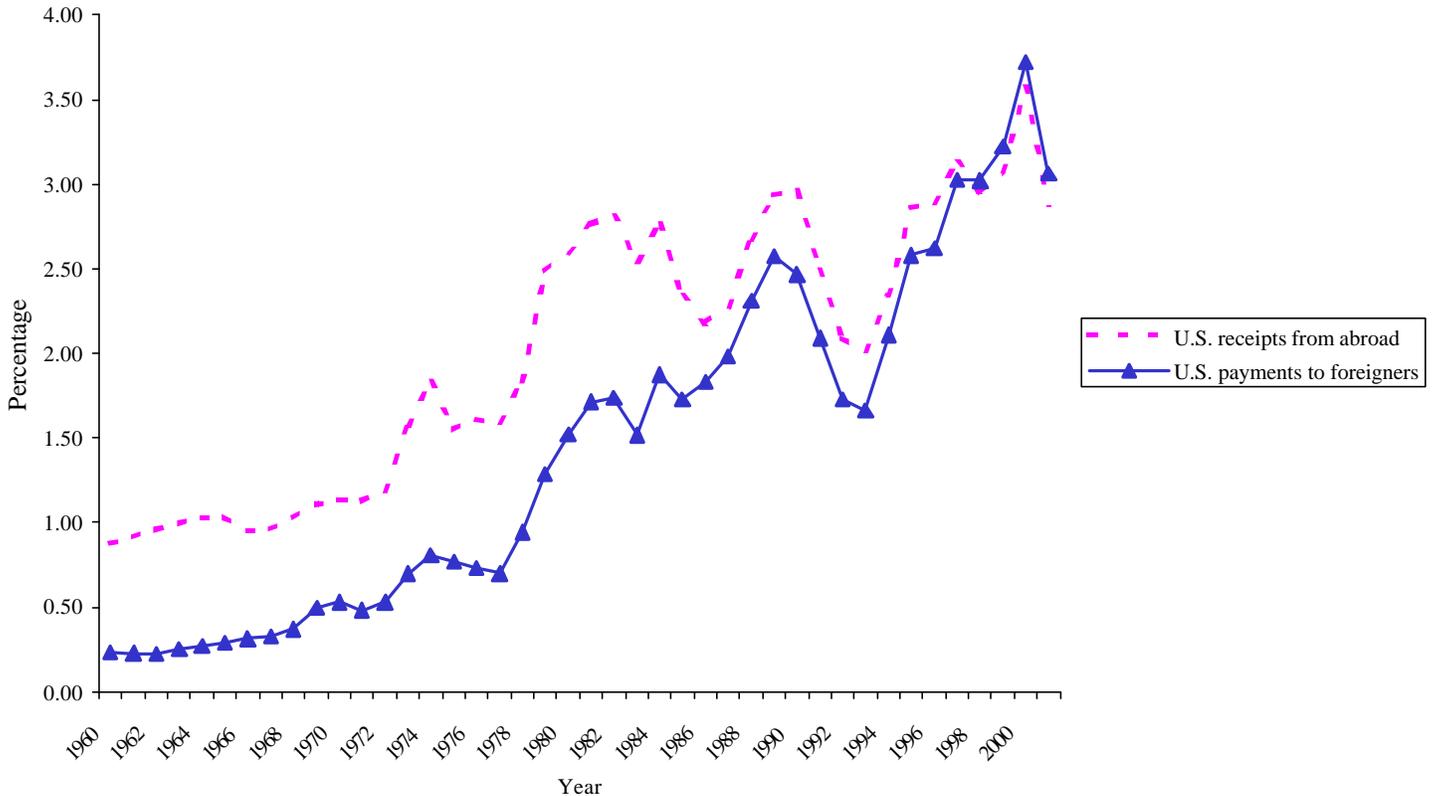
**Receipts of Income from Abroad and U.S. Payments to Foreign Persons, 1960-2001**  
[millions nominal dollars]



Source: Department of Commerce, Bureau of Economic Analysis.

**Figure 9**

**Receipts of Income from Abroad and U.S. Payments to Foreign Persons  
as a Percentage of GDP, 1960-2001  
(percent)**



Source: Department of Commerce, Bureau of Economic Analysis.

Intra-firm trade

These aggregate data also do not reveal the extent to which growing trade flows result from trade between related parties. For example, a domestic company might ship components manufactured in the United States to its foreign subsidiary for final assembly and sale. Such shipments would be counted as exports from the United States. A domestic company might produce components abroad and ship them to the United States for final assembly and sale. Such shipments would be counted as imports to the United States. Likewise, a foreign parent company might ship components from abroad to its U.S. affiliate for final assembly and sale in the United States. Such shipments would be counted as imports into the United States. The foreign affiliate might ship components to another country for assembly and sale. Such shipments would be counted as exports from the United States.

The preceding paragraph suggests that intra-firm trade involves the shipment of components across borders. Other intra-firm trade may involve the shipment of raw materials abroad for manufacture abroad or shipment of finished goods to a foreign sales affiliate. The data do not permit such distinctions to be drawn. Nevertheless, the extent of this intra-firm cross-border trade is large. In 1996, large foreign-owned domestic corporations reported sales of tangible goods to related foreign persons (exports) of \$68.6 billion, a figure representing 11.2 percent of total U.S. merchandise exports in 1996. Large foreign-owned domestic corporations reported purchases of tangible goods from related foreign persons (imports) of \$181.9 billion, a figure representing 22.6 percent of total U.S. merchandise imports in 1996.<sup>31</sup> Similarly, in 1996, U.S. multinational enterprises shipped \$162.4 billion of goods to their foreign affiliates, a figure representing 26 percent of U.S. merchandise exports in 1996. Foreign affiliates of U.S. multinational enterprises shipped \$136.1 billion of goods to their U.S. parent enterprise, a figure representing 16.9 percent of U.S. merchandise imports in 1996.<sup>32</sup> Thus, in total, in 1996 intra-firm trade accounted for at least 37 percent of U.S. merchandise exports and 39 percent of U.S. merchandise imports.

#### Merchandise trade data by industry and geographic region

Intra-firm trade helps explain two other aspects of merchandise trade. First, sectors that are important sources of U.S. exports are often also substantial import sectors. For example, a U.S. manufacturer of computer equipment may produce some components in the United States and ship the components abroad for assembly before re-importing the product for sale in the United States. Such a business arrangement would produce exports from the computer and computer components sector and imports into the computer and computer component sector. Beyond intra-firm trade, competition in the market place also would result in the same sector being the source of exports and the recipient of imports. Figure 10 and Figure 11 detail the composition, by industry, of U.S. merchandise exports (Figure 10) and U.S. merchandise imports (Figure 11) for 2000. To highlight the example above, the data show that seven percent of U.S. exports were from the computer and peripherals industry and similarly seven percent of U.S. imports were in the computer and peripherals industry.

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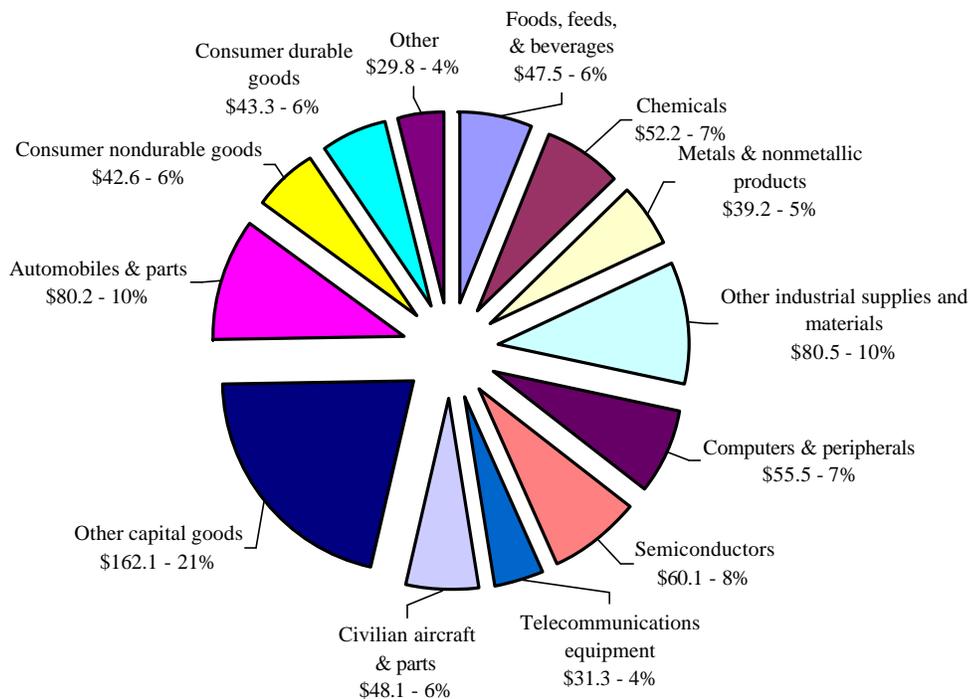
<sup>31</sup> Michael G. Seiders and Heather R. Duffy, "Transactions Between Large Foreign-Owned Domestic Corporations and Related Foreign Persons, 1996," *SOI Bulletin*, 19, Fall 1999, pp. 192-213. The data are from 545 foreign-owned domestic corporations, each with total receipts of \$500 million or more in 1996 or a prior year. The figures reported in the text are the sum of reported "sales of stock in trade" and "sales of other tangible property." In 1991, such inter-affiliate trade by large foreign-owned domestic corporations represented 11 percent of merchandise exports and 24 percent of merchandise imports. In 1994, such inter-affiliate trade by large foreign-owned domestic corporations represented 14 percent of merchandise exports and 27 percent of merchandise imports.

<sup>32</sup> Raymond J. Mataloni, Jr. "U.S. Multinational Companies: Operations in 1996," *Survey of Current Business*, 78, September 1998, p. 54. Unlike the data cited above for foreign-owned U.S. corporations, these data are more inclusive of U.S. foreign affiliates, not being restricted by the size of the foreign affiliate.

Intra-firm trade also is a factor in understanding why countries or areas that are important export markets also often are significant points of origin of imports. Figure 12 and Figure 13 show the destinations of U.S. merchandise exports and the areas of origin of U.S. merchandise imports in 2000.<sup>33</sup>

**Figure 10**

**Composition, by Industry of U.S. Merchandise Exports, 2000**  
**[Billions of Dollars and Percentage]**

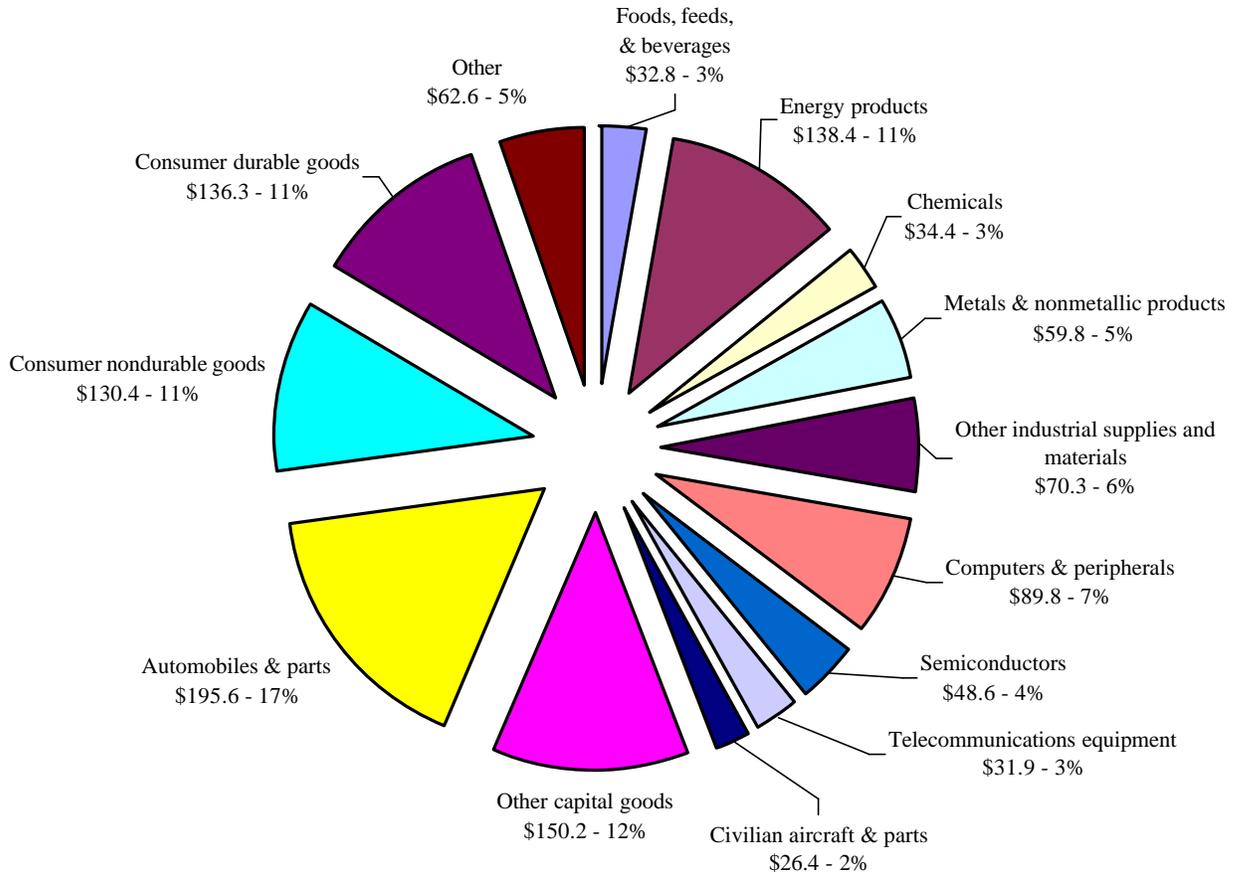


Source: Bureau of Economic Analysis, Department of Commerce and JCT staff calculations.

<sup>33</sup> Data for Figure 10 through Figure 13 are found in Douglas B. Weinberg, "U.S. International Transactions, First Quarter 2001," *Survey of Current Business*, 81, July 2001, pp. 37-81.

**Figure 11**

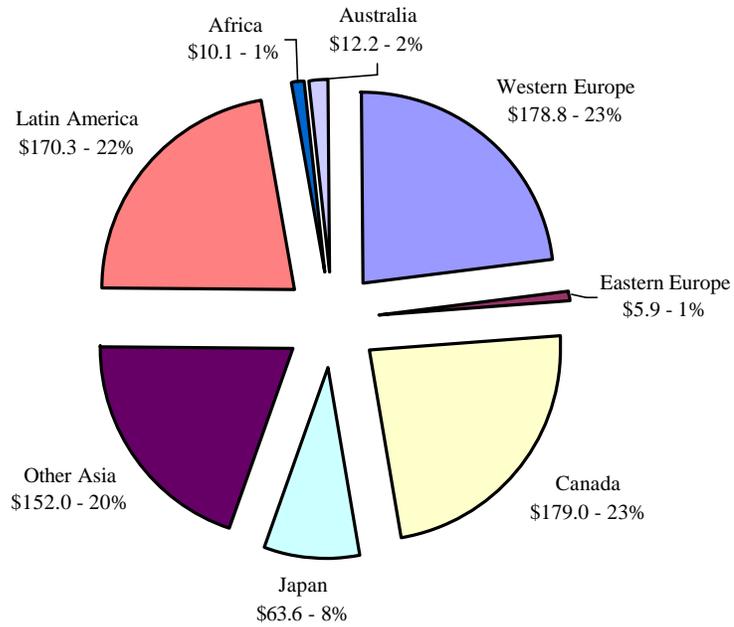
**Composition, by Industry of U.S. Merchandise Imports, 2000**  
[Billions of Dollars and Percentage]



Source: Bureau of Economic Analysis, Department of Commerce and JCT staff calculations.

**Figure 12**

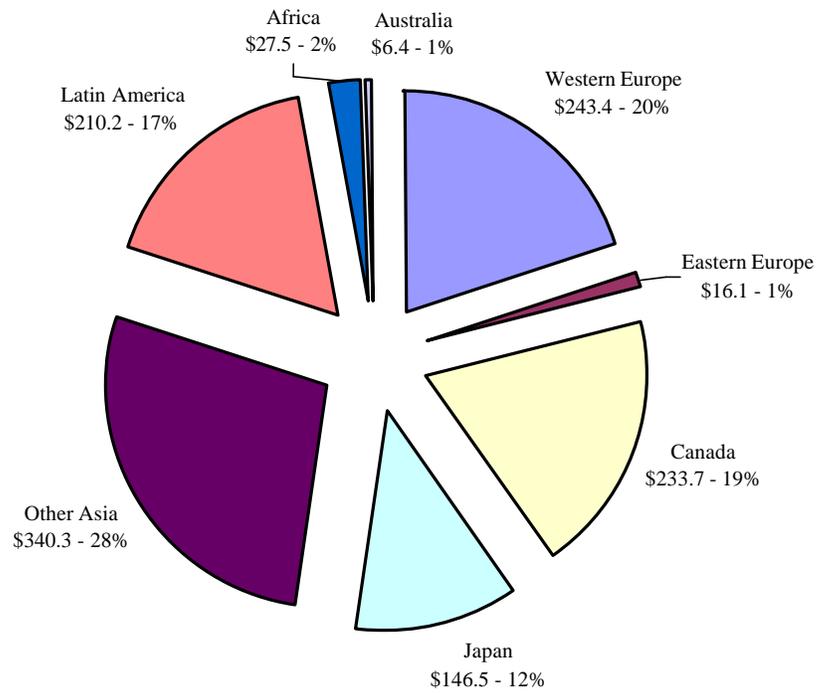
**Destination of U.S. Merchandise Exports, 2000**  
**[Billions of Dollars and Percentage]**



Source: Bureau of Economic Analysis, Department of Commerce and JCT staff calculations.

**Figure 13**

**Areas of Origin of U.S. Merchandise Imports, 2000**  
**[Billions of Dollars and Percentage]**



Source: Bureau of Economic Analysis, Department of Commerce and JCT staff calculations.

## C. Trends in the United States' Financial Account

### Overview of the United States' financial account

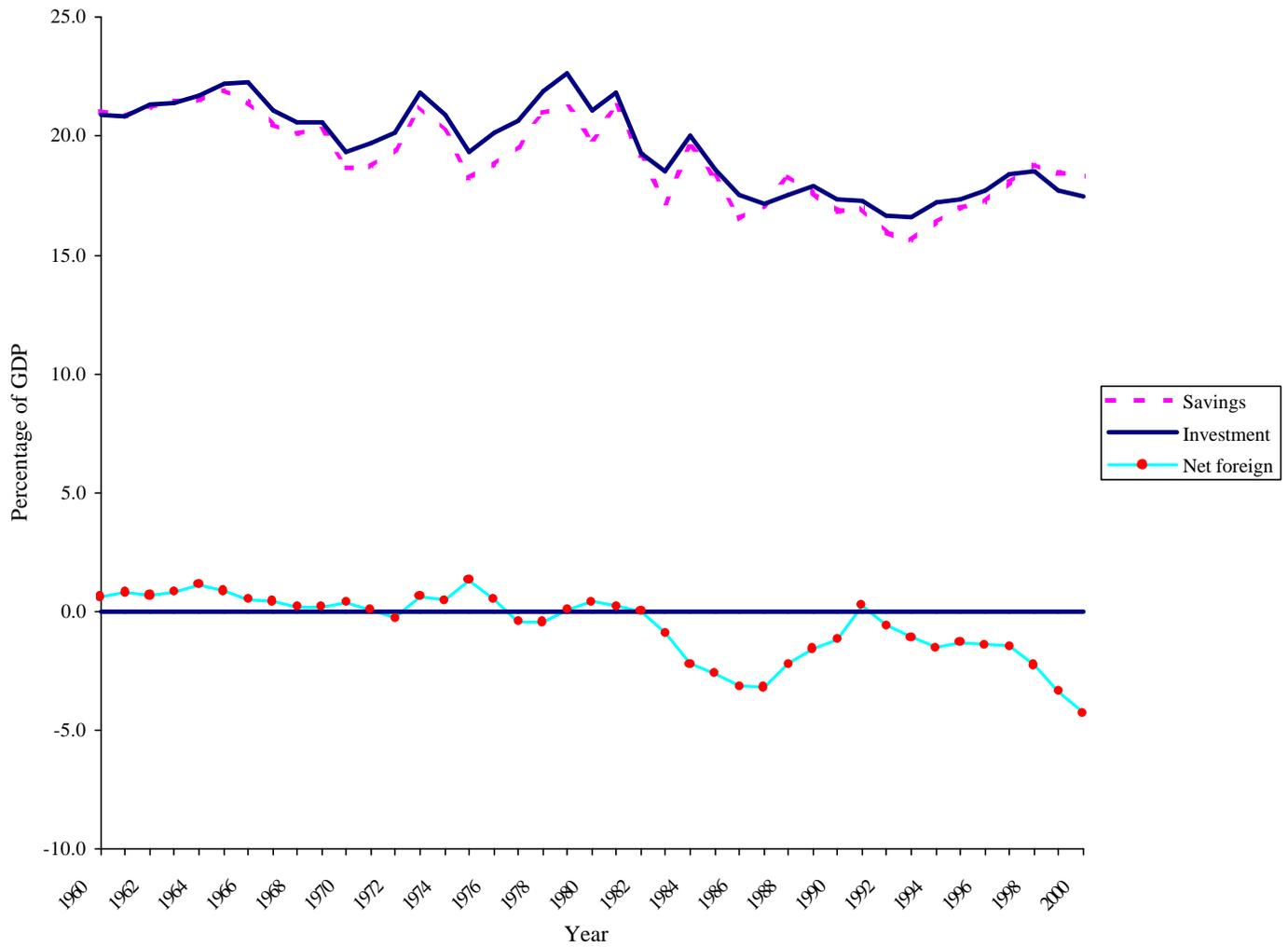
As explained above, when the United States imports more than it exports, the dollars the United States uses to buy the imports must ultimately return to the United States as payment for U.S. exports or to purchase U.S. assets. As Figure 2, Figure 3, and Table 1 document, the United States' current account has been in deficit since the early 1980s. Figure 14 plots gross (before depreciation) U.S. investment and gross U.S. saving as a percentage of GDP for the period 1960-2000.<sup>34</sup> Figure 14 also plots net foreign investment as a percentage of GDP. In Figure 14, when the United States is a net exporter of capital, net foreign investment is measured as a positive number, and when the United States is a net importer of foreign capital net foreign investment is measured as a negative number. Net foreign investment became a larger proportion of the economy since 1982. At the same time, the United States changed from being a modest exporter of capital in relation to GDP to being a large importer of capital. Net foreign investment has become a larger proportion of the economy and a more significant proportion of total domestic investment than in the past. In 2000, gross investment in the United States was \$1,741 billion and net foreign investment was \$428 billion, or 24.6 percent of gross domestic investment. In 1993, net foreign investment comprised 8.9 percent of gross domestic investment.

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<sup>34</sup> Data for Figure 14 are from the U.S. Department of Commerce, Bureau of Economic Analysis and are reprinted in Appendix 2.

Figure 14

Saving, Investment, and Net Foreign Investment as a Percentage of GDP,  
1960-2000

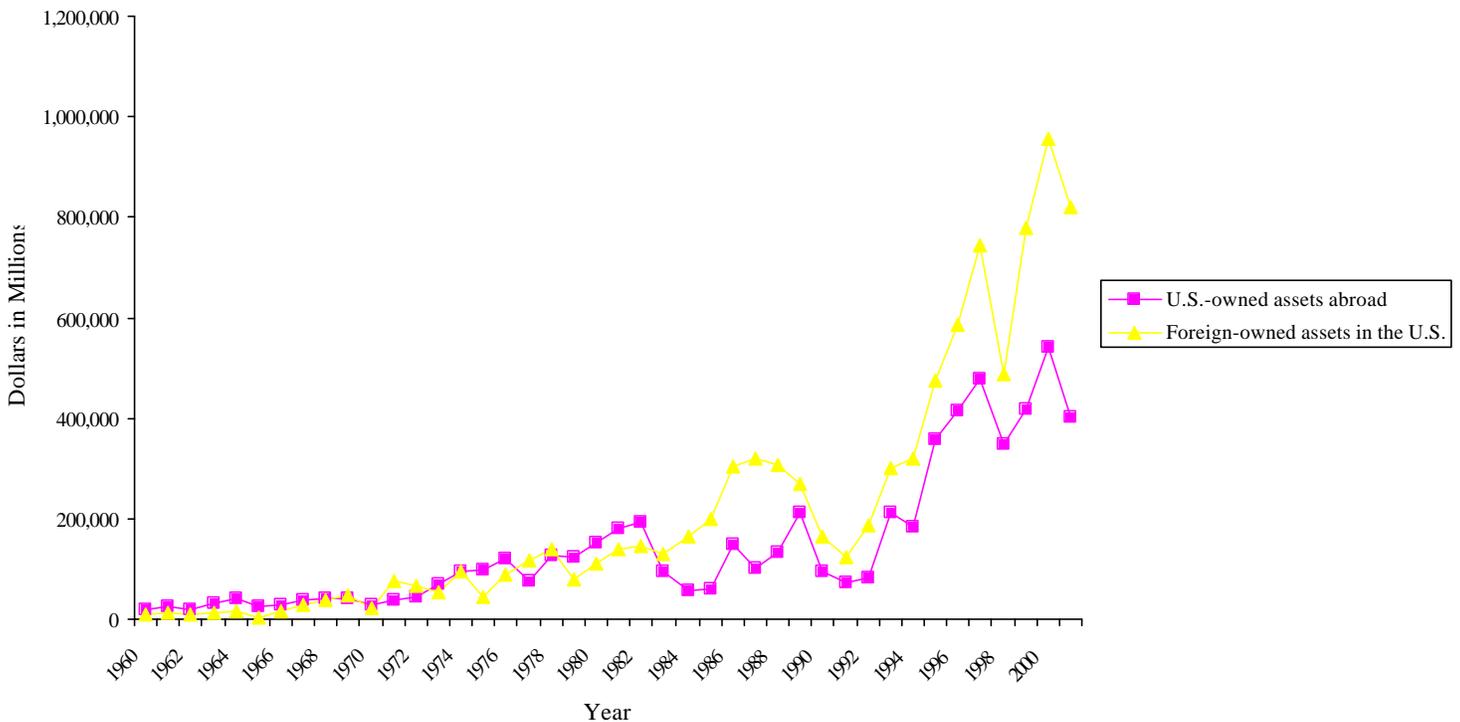


Source: Department of Commerce, Bureau of Economic Analysis.

The net foreign investment in the United States is measured by the United States' financial account. The financial account measures the increase in U.S. assets abroad compared to the increase in foreign assets in the United States. Figure 15 plots the annual increase of U.S. assets abroad and of foreign assets in the United States in constant dollars for the period 1960-2001.<sup>35</sup> Foreign assets in the United States increased by \$814 billion in 1999, \$1,024 billion in 2000, and \$895 billion in 2001 in nominal dollars. At the same time, foreign assets owned by U.S. persons increased by \$437 billion in 1999, \$581 billion in 2000, and \$400 billion in 2001 (nominal dollars).

**Figure 15**

**Annual Increase in U.S. Assets Abroad and in Foreign Assets in U.S.,  
1960-2001, in Constant 1996 Dollars**



Source: Department of Commerce, Bureau of Economic Analysis.

<sup>35</sup> Data for Figure 15 are from the U.S. Department of Commerce, Bureau of Economic Analysis and are reprinted in Appendix 3.

## **Growth in foreign-owned assets in the United States and U.S.-owned assets abroad**

### Overview

Measured in nominal dollars, the amount of foreign-owned assets in the United States grew more than 700 percent between 1975 and 1988<sup>36</sup> and by nearly 400 percent between 1980 and 2000. The total amount of foreign-owned assets in the United States exceeded \$8 trillion by the end of 2000.<sup>37</sup> The recorded value of U.S.-owned assets abroad grew less rapidly during the same period. The Department of Commerce reports that in 1975 the amount of U.S.-owned assets abroad exceeded foreign-owned assets in the United States by \$74 billion. By the end of 1988, however, the situation had reversed, so that the amount of foreign-owned assets in the United States exceeded U.S.-owned assets abroad by \$162 billion. By 2000, the amount of foreign-owned assets in the United States exceeded U.S.-owned assets abroad by \$1.8 trillion.<sup>38</sup> These investments are measured at their so-called “current cost.”<sup>39</sup> Some argue that the market value of U.S.-owned assets abroad is similar to, or greater than, the market value of foreign-owned assets in the United States, if market values were measured accurately.<sup>40</sup> Figure 16 and Figure 17 display the value of U.S.-owned assets abroad and foreign-owned assets in the United States for selected years measured under both current cost and based on estimates of current market values. Whether this argument is correct with respect to the current net investment position, it is clear that foreign-owned U.S. assets are growing more rapidly than U.S.-owned assets abroad, as depicted in Figure 15.

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<sup>36</sup> Russell B. Scholl, “The International Investment Position of the United States in 1988,” *Survey of Current Business*, U.S. Department of Commerce, Bureau of Economic Analysis, June 1989, p. 43.

<sup>37</sup> *Ibid.*

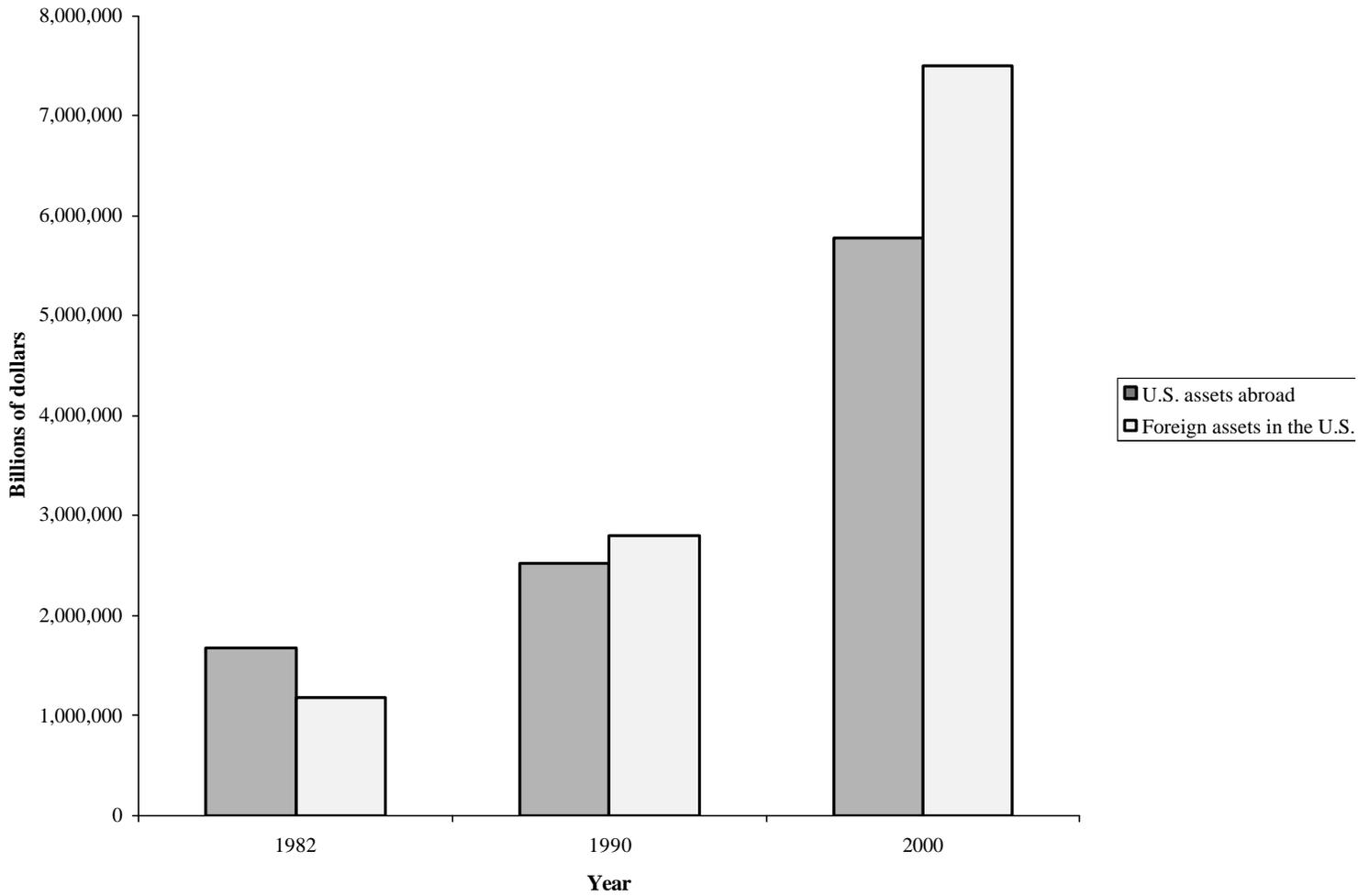
<sup>38</sup> *Ibid.*

<sup>39</sup> The Bureau of Economic Analysis estimates the values of U.S. foreign direct investment abroad and foreign direct investment in the United States using three different bases: historical cost, current cost, and market value. Using the historical cost base, assets are measured according to values carried on taxpayers’ books. Thus, investments reflect the price level of the year in which the asset was acquired. Under the current cost measure, a parent’s share of its affiliates’ tangible assets (property, plant, and equipment and inventories) is revalued from historical cost to replacement cost. Under the market value measure, an owner’s equity in foreign assets is revalued to current market value using indexes of stock prices.

<sup>40</sup> The distinction between book valuation and market valuation is only relevant for the category of investment labeled “direct investment,” not for “portfolio investment.” The distinction between direct and portfolio investment is explained in the text below.

**Figure 16**

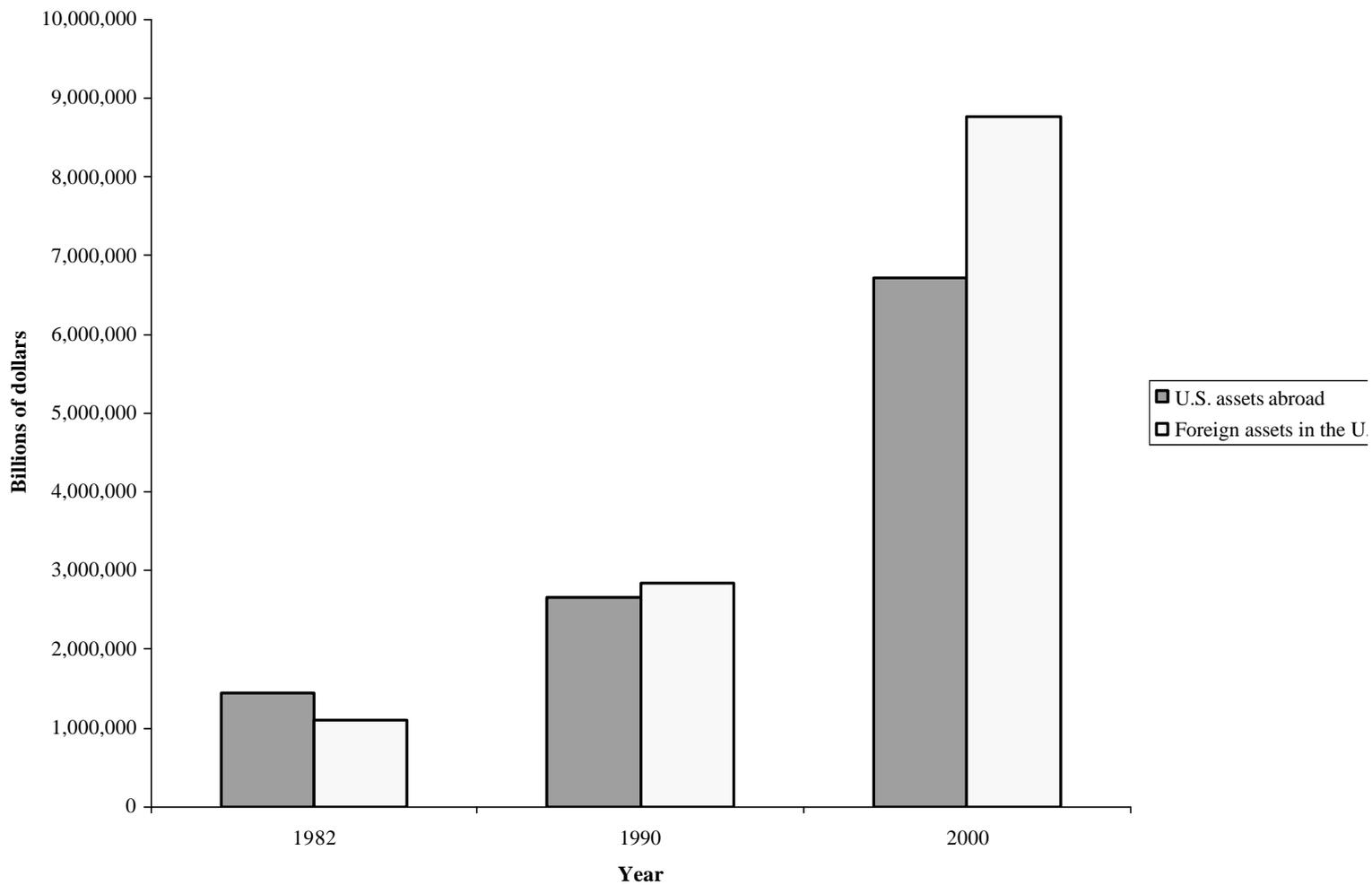
**International Investment Position of the United States,  
1982, 1990, and 2000 in Constant 1996 Dollars  
(direct investment at current cost)**



Source: Department of Commerce, Bureau of Economic Analysis.

**Figure 17**

**International Investment Position of the United States,  
1982, 1990, 2000 in Constant 1996 Dollars  
(direct investment at market value)**



Source: Department of Commerce, Bureau of Economic Analysis.

### Direct investment, non-direct (portfolio) investment, and official investment

Foreign assets in the United States (and U.S. assets abroad) can be categorized as direct investment, non-direct investment, and official assets. Direct investment constitutes assets over which the owner has direct control. The Department of Commerce defines an investment as direct when a single person owns or controls, directly or indirectly, at least 10 percent of the voting securities of a corporate enterprise or the equivalent interests in an unincorporated business. Foreign persons held direct investments of \$1.37 trillion in the United States in 2000, having grown from \$127 billion in 1980.<sup>41</sup>

The largest category of investment is non-direct investment held by private (non-governmental) foreign investors, commonly referred to as portfolio investment. For most of the past decade foreign portfolio investment annually has exceeded foreign direct investment, making portfolio investment responsible for the majority of growth in foreign ownership of U.S. assets. (See Figure 18) Foreign portfolio investment consists mostly of holdings of corporate equities, corporate and government bonds, and bank deposits. The portfolio investor generally does not have control over the assets that underlie the financial claims. In 2000, portfolio assets of foreign persons in the United States were more than triple the recorded value of direct investment, \$4.74 trillion compared to \$1.37 trillion, respectively.<sup>42</sup> Bank deposits account for approximately one-quarter of this total, and reflect, in part, the increasingly global nature of banking activities. Figure 19 reports the dollar value of foreign holdings of selected U.S. assets, both portfolio investment and direct investment, for 1982, 1990, and 2000.<sup>43</sup> Foreign investment in bonds, corporate equities, and bank deposits, like other types of financial investment, provide a source of funds for investment in the United States but also represent a claim on future U.S. resources.

The final category of foreign-owned U.S. assets is official assets: U.S. assets held by governments, central banking systems, and certain international organizations. The foreign currency reserves of other governments and banking systems, for example, are treated as official assets. Levels of foreign-held official assets have grown more slowly than foreign-held direct and portfolio investment of private investors.

The value of investments by private U.S. persons abroad has grown from \$693 billion in 1980 to \$5.95 trillion in 2000.<sup>44</sup> This growth has not been as rapid as the growth in the value of investments by foreign persons in the United States. As has been the case for foreign investors in U.S. assets, over the past decade U.S. investors portfolio holdings of foreign assets has increased more rapidly than U.S. foreign direct investment. (See Figure 20.)<sup>45</sup> At year-end

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<sup>41</sup> King, "The International Investment Position of the United States at Yearend 2000."

<sup>42</sup> *Ibid.*

<sup>43</sup> See Appendix 4.

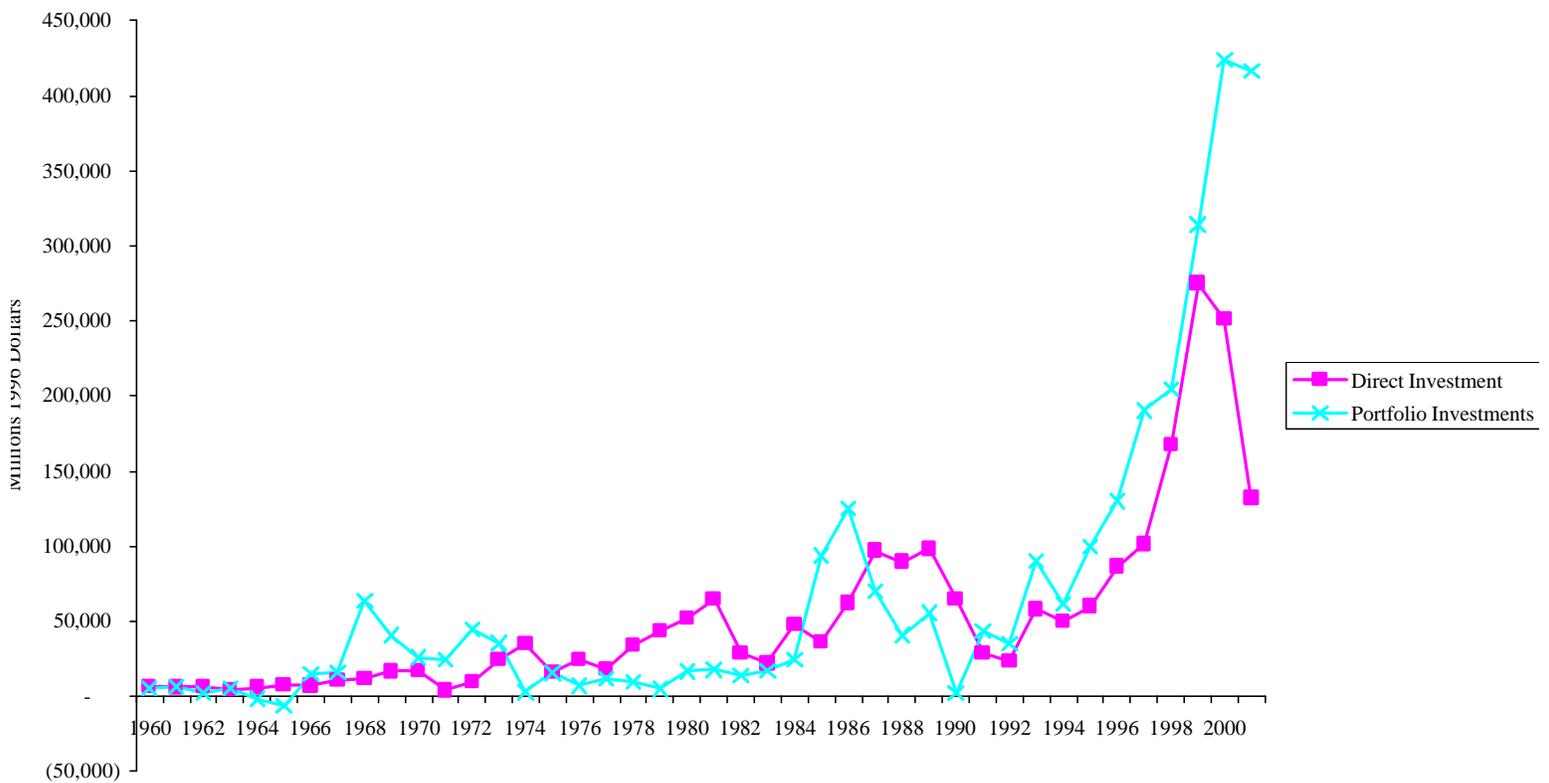
<sup>44</sup> King, "The International Investment Position of the United States at Yearend 2000."

<sup>45</sup> See Appendix 5.

2000, U.S. foreign direct investment constituted approximately one-quarter of U.S. ownership of foreign assets (with direct investment measured at current cost).<sup>46</sup> Measured at current cost, the value of U.S. direct investment abroad has remained above the value of foreign direct investment in the United States. (See Figure 21.) Measured at market value, the value of foreign direct investment in the United States has modestly surpassed the value of U.S. direct investment abroad since 1998. (See Figure 22.)

**Figure 18**

**Annual Increase in Foreign Direct Investment in the United States and Foreign (Non-Treasury Security) Portfolio Investment, 1960-2001, In Constant 1996 Dollars**

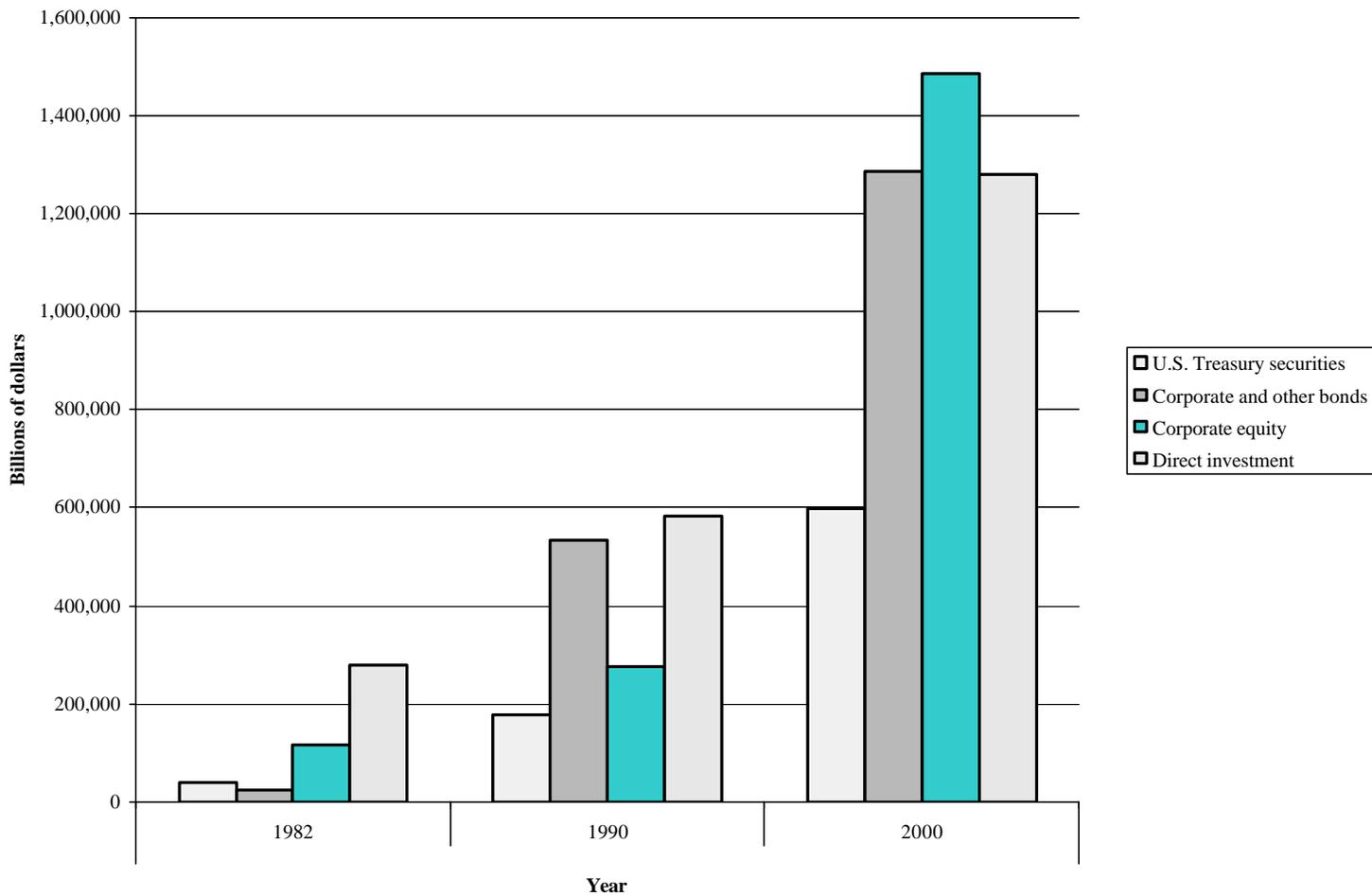


Source: Department of Commerce, Bureau of Economic Analysis.

<sup>46</sup> King, "The International Investment Position of the United States at Yearend 2000."

**Figure 19**

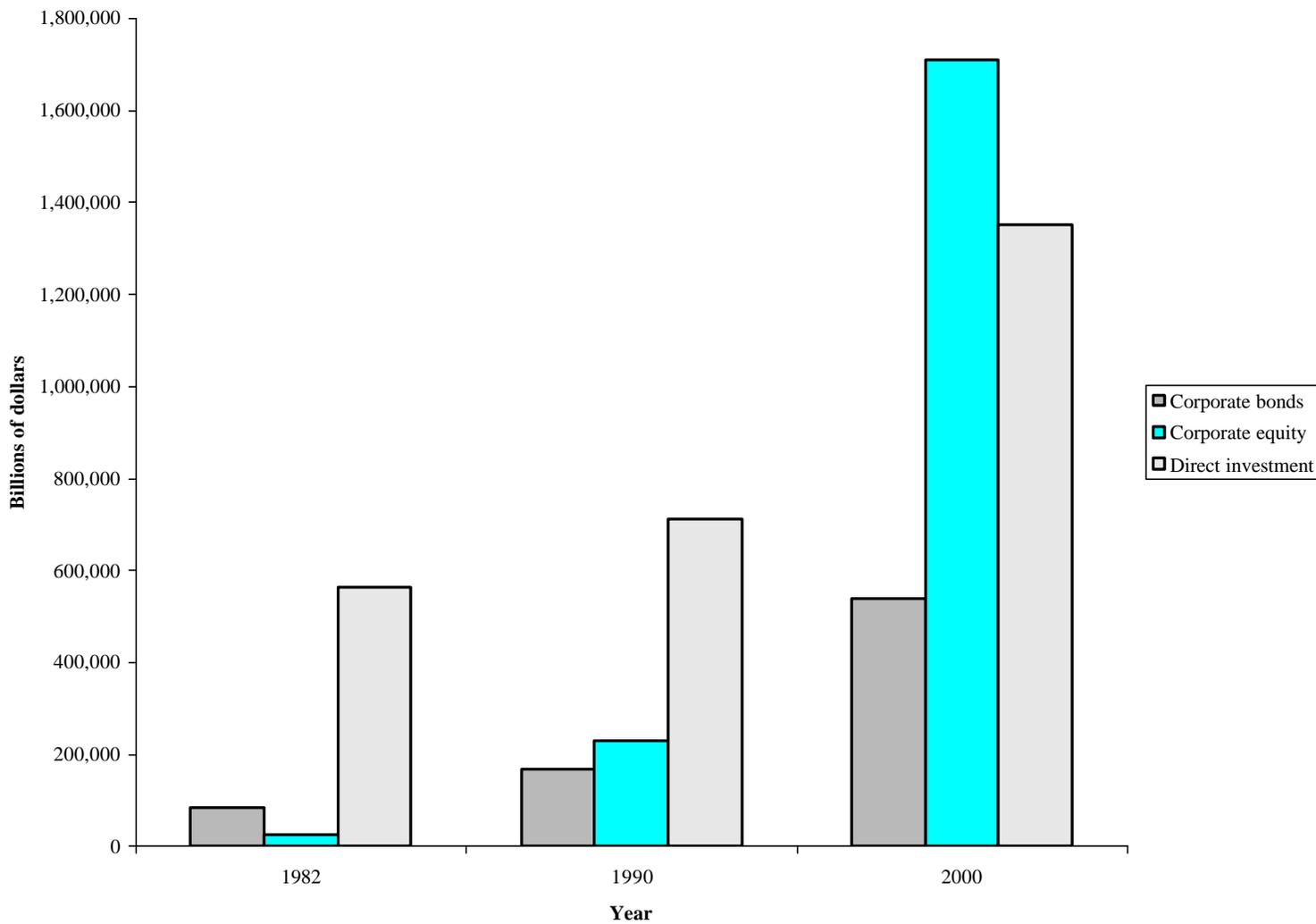
**Selected Nongovernmental Foreign Holdings of United States' Assets, Both Portfolio and Direct Investments,  
1982, 1990, 2000 in Constant 1996 Dollars  
(direct investment at current cost)**



Source: Department of Commerce, Bureau of Economic Analysis.

**Figure 20**

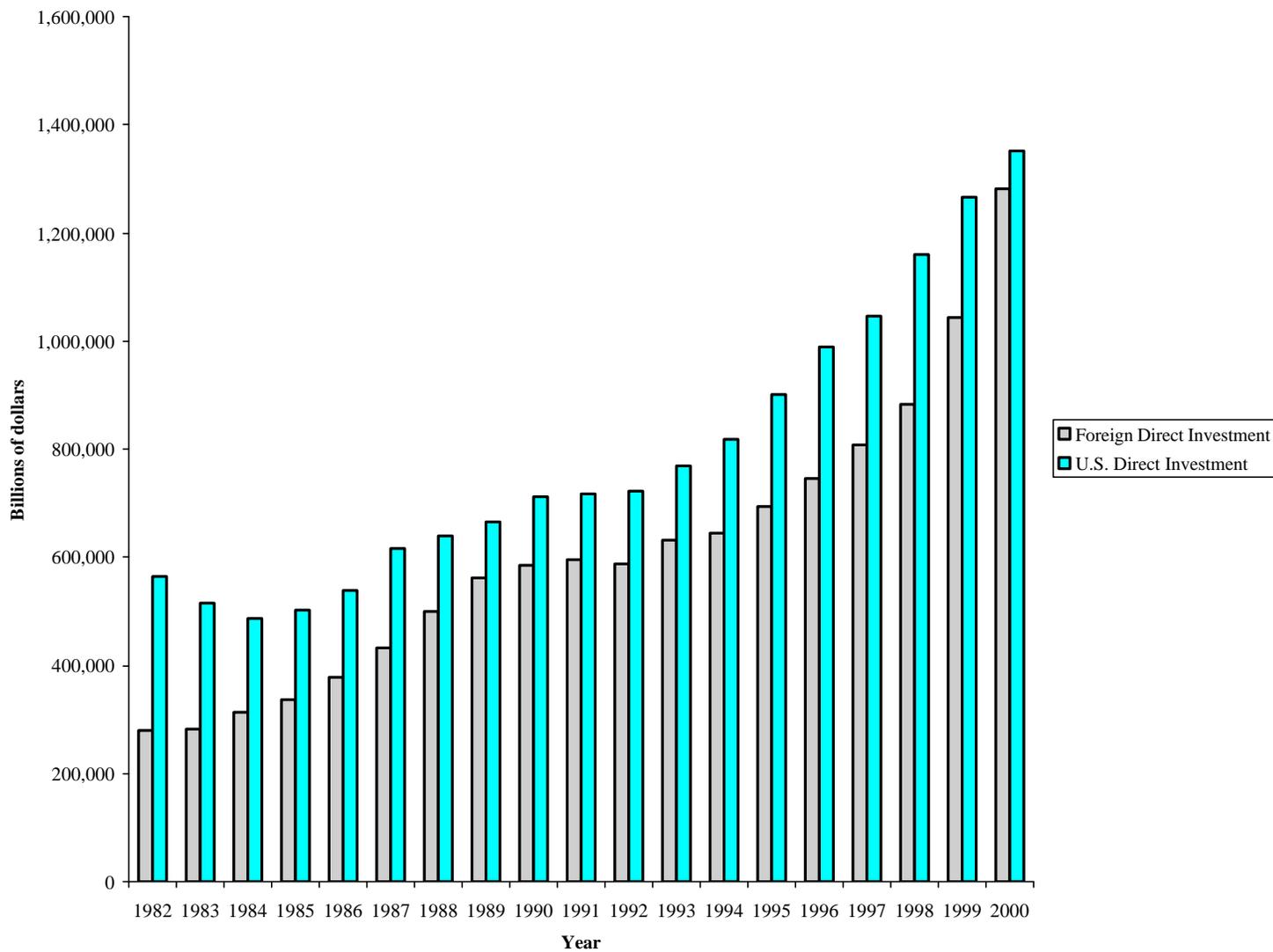
**Selected United States' Holdings of Foreign Assets, Both Portfolio  
and Direct Investments, 1982, 1990, 2000, in Constant 1986 Dollars  
(direct investment at current cost)**



Source: Department of Commerce, Bureau of Economic Analysis.

**Figure 21**

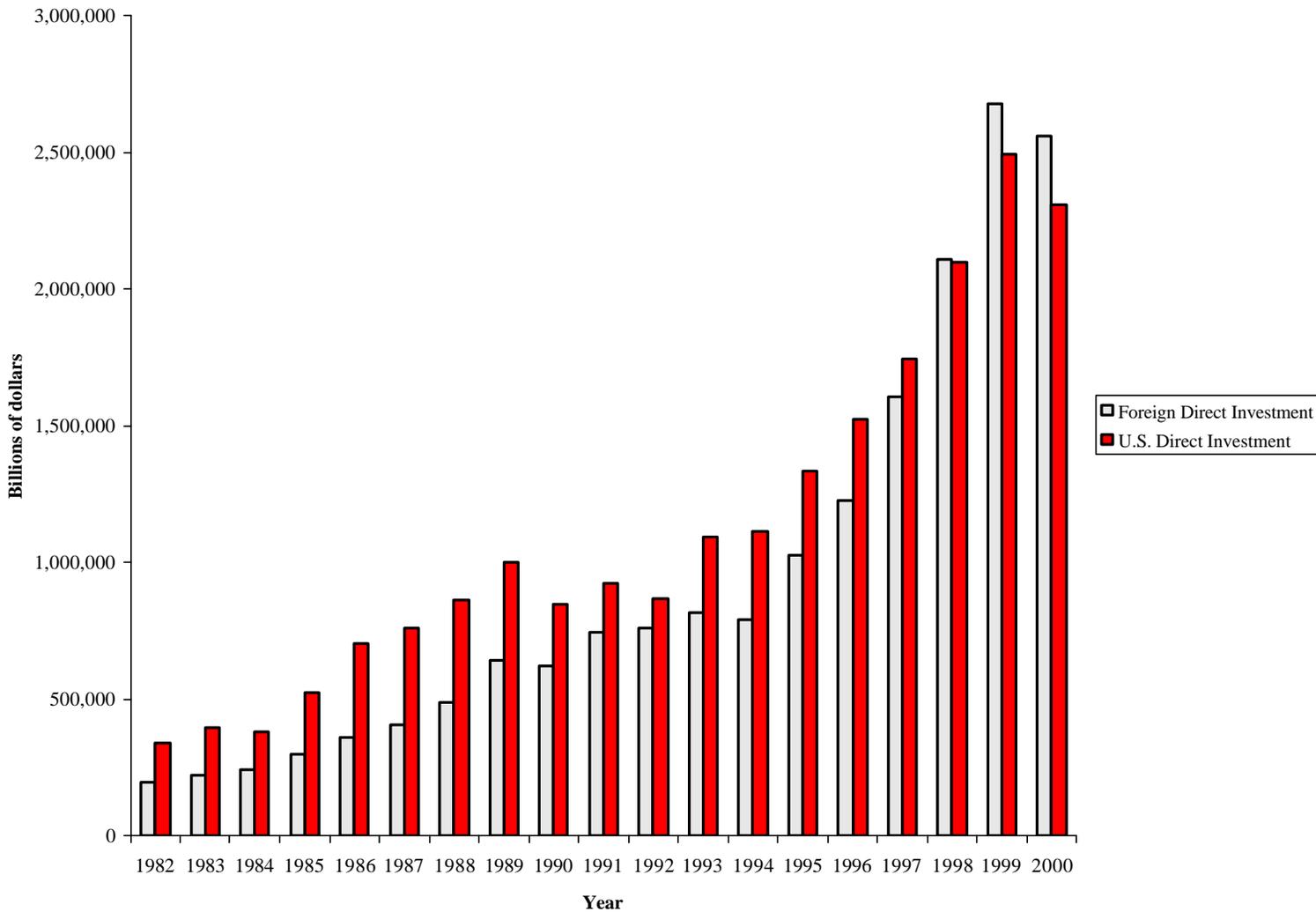
**Year-End Value of Foreign Direct Investment in the United States  
and U.S. Direct Investment Abroad, 1982-2000**  
[Billions of Nominal Dollars at Current Cost]



Source: Department of Commerce, Bureau of Economic Analysis.

**Figure 22**

**Year-End Value of Foreign Direct Investment in the United States  
and U.S. Direct Investment Abroad, 1982-2000**  
[Billions of Nominal Dollars at Market Value]



Source: Department of Commerce, Bureau of Economic Analysis.

### Cross border investment by geographic region and industry<sup>47</sup>

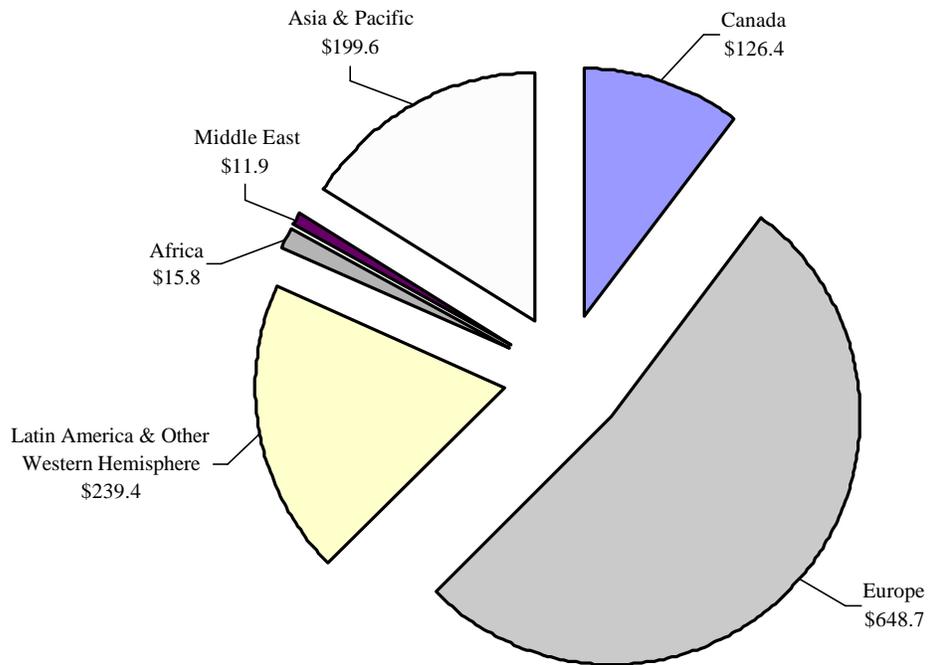
Most cross border investment by developed countries is located in other developed countries. Measured on an historical cost basis, more than 50 percent of U.S. direct investment abroad is located in Europe and more than 10 percent is located in Canada. (See Figure 23.) Similarly, European persons account for more than 70 percent of foreign direct investment in the United States on an historical cost basis, and Canadian persons account for more than eight percent of foreign direct investment in the United States. (See Figure 24.) The single largest country hosting U.S. foreign direct investment abroad is the United Kingdom, followed by Canada, the Netherlands, and Germany. The United Kingdom is the single largest source country for foreign direct investment in the United States, followed by Japan, the Netherlands, and Germany. (See Figure 25 and Figure 26.) More than one quarter of U.S. direct investment abroad has been devoted to manufacturing. More than 40 percent of foreign direct investment in the United States is in the manufacturing sectors. Other significant sectors in which U.S. persons make direct investments abroad and in which foreign persons make direct investments in the United States are finance, insurance, and petroleum. (See Figure 27, Figure 28 and Figure 29).

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<sup>47</sup> The data in the text below and accompanying figures is from Maria Borgo and Raymond Mataloni, Jr., "Direct Investment Positions for 2000: Country and Industry Detail," *Survey of Current Business*, 81, July 2001, pp. 16-29.

**Figure 23**

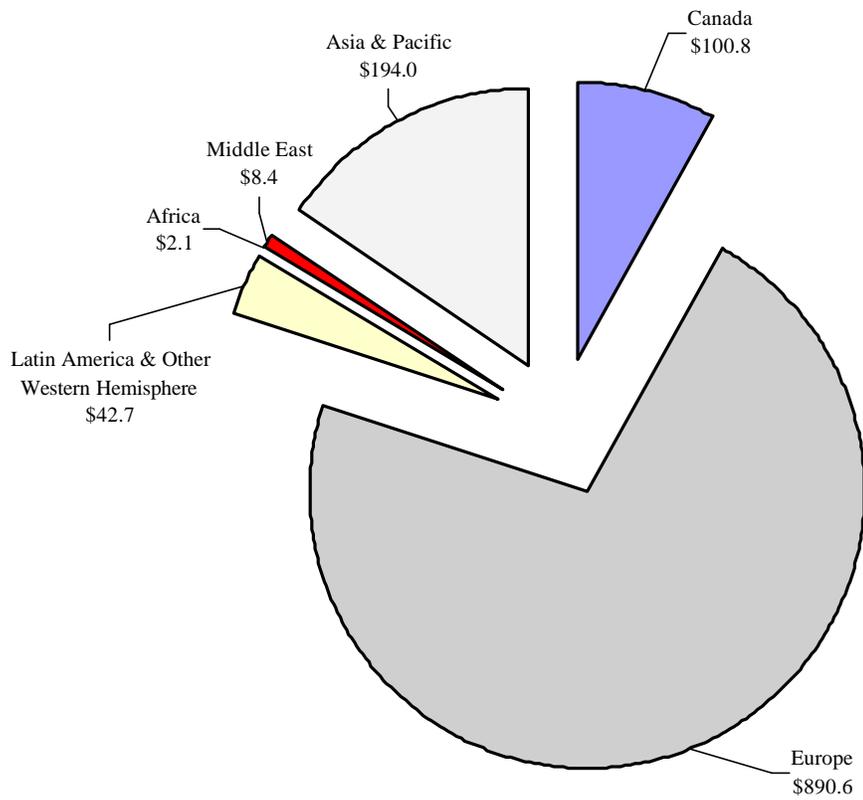
**U.S. Direct Investment Abroad, 2000  
[Billions of Dollars]**



Source: Department of Commerce, Bureau of Economic Analysis.

**Figure 24**

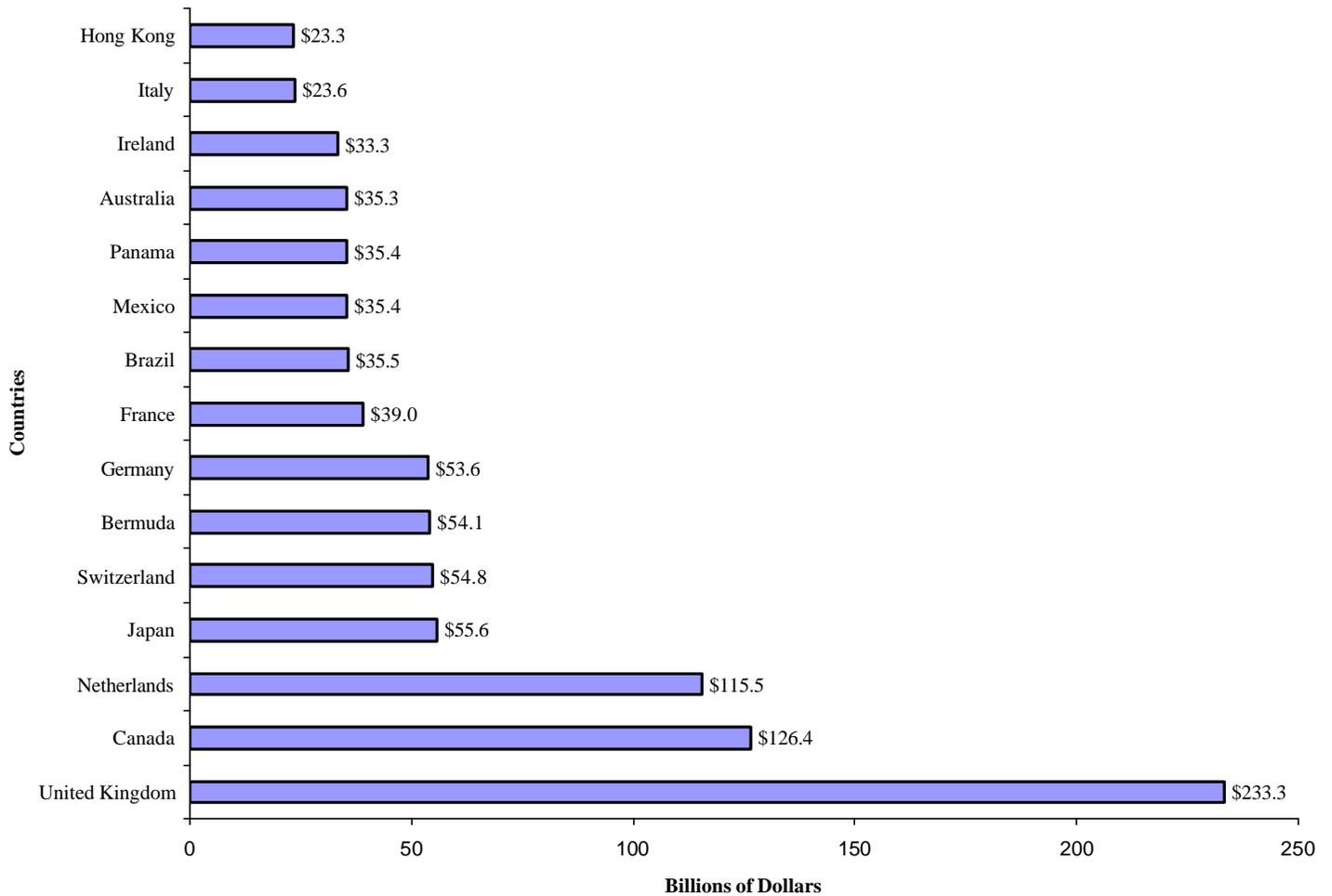
**Foreign Direct Investment in the United States, 2000 Historical Cost Basis  
[Billions of Dollars]**



Source: Department of Commerce, Bureau of Economic Analysis.

**Figure 25**

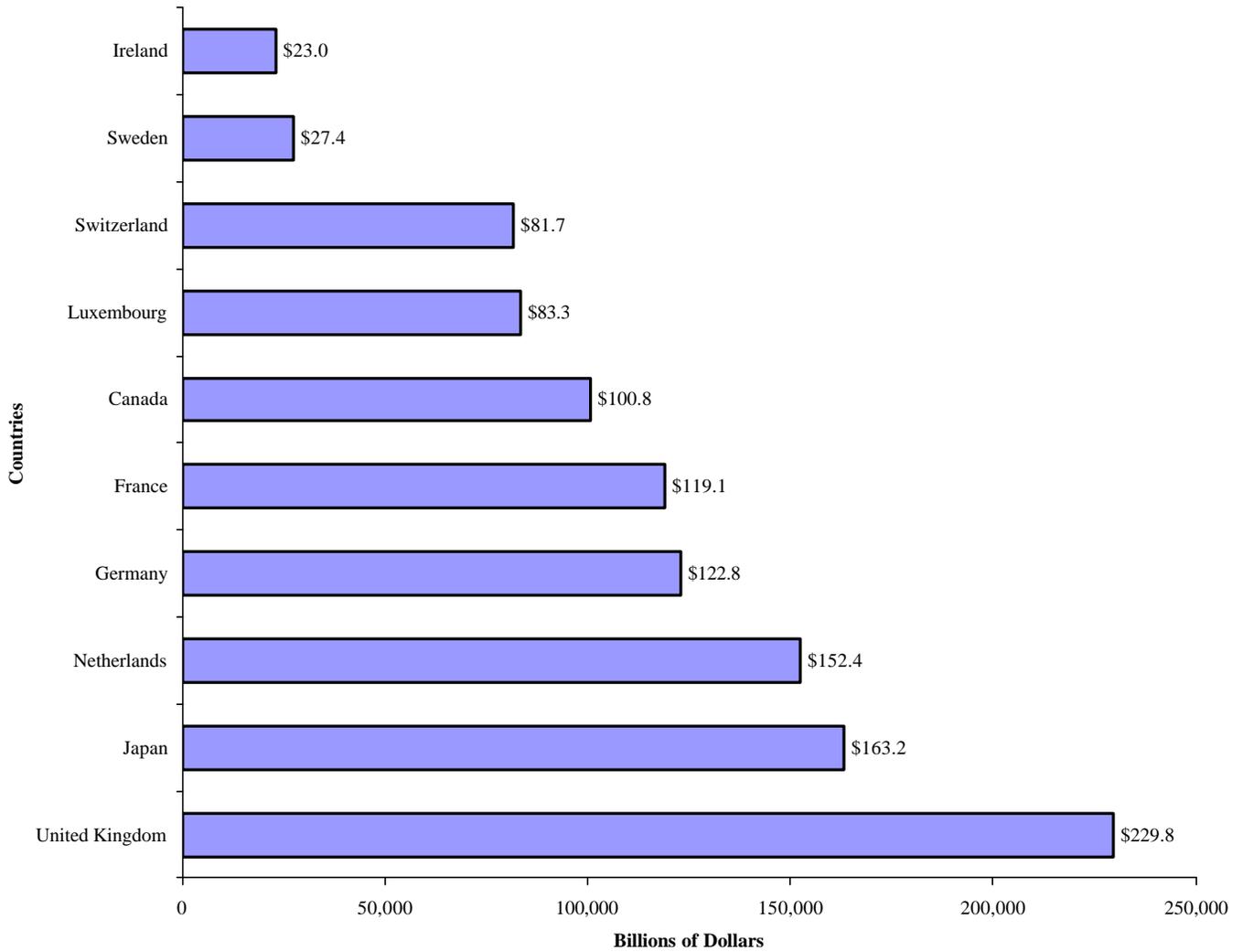
**15 Largest Host Countries of U.S. Direct Investment Abroad, 2000**  
**[Billions of Dollars]**



Source: Department of Commerce, Bureau of Economic Analysis.

**Figure 26**

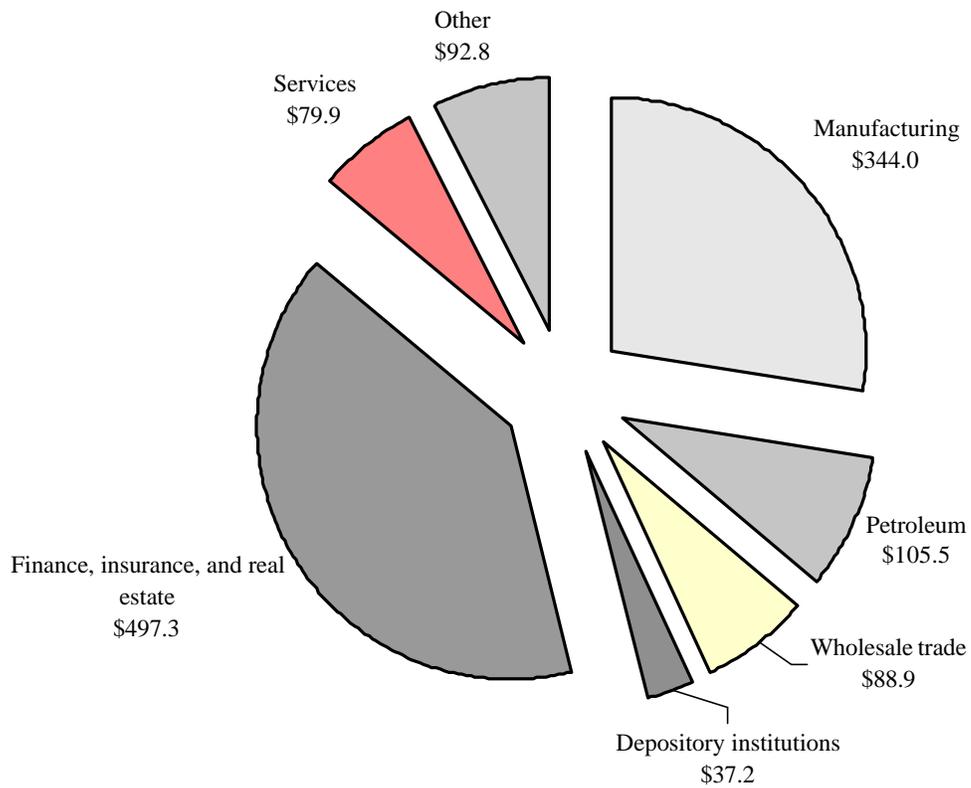
**10 Largest Home Countries of Foreign Direct Investment  
in the United States, 2000  
[Billions of Dollars]**



Source: Department of Commerce, Bureau of Economic Analysis.

**Figure 27**

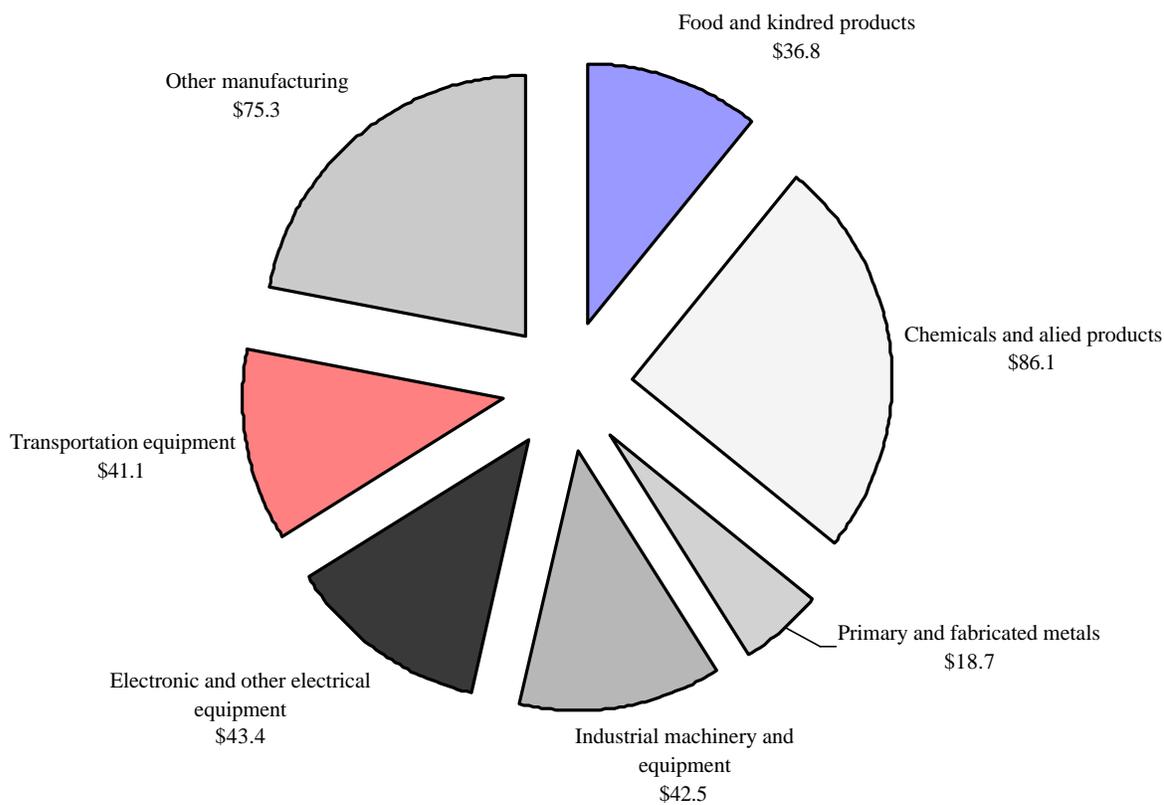
**U.S. Direct Investment Abroad at Year-End 2000  
by Industry on an Historical Cost Basis  
[Billions of Dollars]**



Source: Department of Commerce, Bureau of Economic Analysis.

**Figure 28**

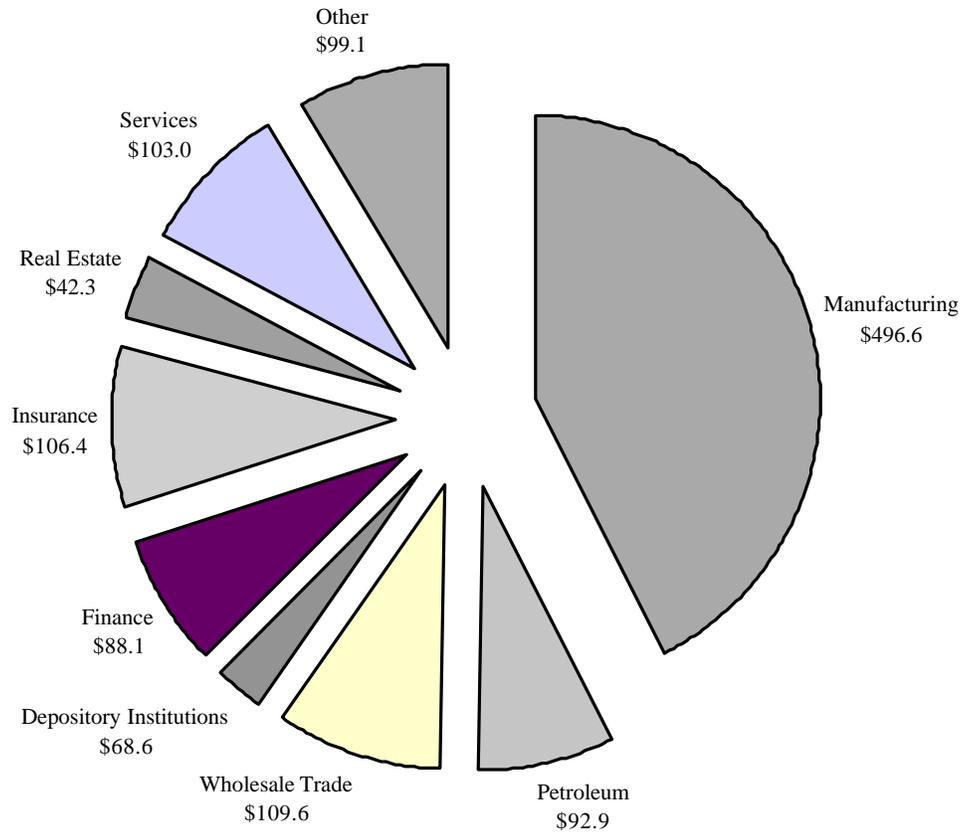
**U.S. Direct Investment in Manufacturing Abroad at  
Year-End 2000 by Manufacturing Industry on an  
Historical Cost Basis  
[Billions of Dollars]**



Source: Department of Commerce, Bureau of Economic Analysis.

**Figure 29**

**Foreign Direct Investment in the United States by Industry, 2000**  
[Billions of Dollars]



Source: Department of Commerce, Bureau of Economic Analysis.

## Cross-border merger activity

Cross-border merger activity is one means by which changes occur in the financial account. Figure 30 below details the dollar value of foreign investor acquisitions of U.S. companies and the U.S. investor acquisitions of foreign companies via merger or acquisition. All of these mergers would represent direct, rather than portfolio, investment, as all involve 100-percent acquisitions.<sup>48</sup> Figure 30 shows that the dollar value of such cross-border acquisitions was comparable with U.S. acquisitions slightly lower for the period 1991 through 1997. Subsequent to 1997 foreign acquisitions of U.S. companies has more than doubled U.S. acquisitions of foreign companies, although throughout the entire period U.S. acquisitions generally have exceeded foreign acquisitions in terms of number of companies purchased.<sup>49</sup>

The greatest plurality of cross-border mergers and acquisitions has involved U.S. companies and companies of the United Kingdom, consistent with the data presented above showing the extent of U.K. direct investments in the United States and U.S. direct investments in the United Kingdom. In 2000, the investors domiciled in the United Kingdom accounted for nearly 34 percent of foreign acquisitions of U.S. companies (valued at \$114.3 billion).<sup>50</sup> Approximately 35 percent of U.S. investor acquisitions of foreign companies involved companies domiciled in the United Kingdom (valued at \$47.9 billion).<sup>51</sup> The next four largest foreign acquirers of U.S. companies in 2000 were France (\$39.8 billion, 11.7 percent of the total), Switzerland (\$35.6 billion, 10.5 percent of the total), the Netherlands (\$31.8 billion, 9.4 percent of the total), and Canada (\$29.2 billion, 8.6 percent of the total). After the United Kingdom the next largest sites of U.S. investor acquisitions in 2000 were Canada (\$13.8 billion, 10.2 percent of the total), Italy (\$11.8 billion, 8.7 percent of the total), Japan (\$10.7 billion, 7.9 percent of the total), and Germany (\$6.7 billion, 5.0 percent of the total).<sup>52</sup> Measured by dollar value, approximately 17 percent of foreign acquisitions were of U.S. firms engaged in investments and commodities and another 15 percent of foreign acquisitions were of U.S. firms engaged in providing business services.<sup>53</sup> The foreign industry receiving the greatest U.S. investor purchases was telecommunications, accounting for nearly 13 percent of U.S. foreign

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<sup>48</sup> An investment is considered a “direct investment,” rather than a “portfolio investment,” if at least a 10-percent interest is acquired.

<sup>49</sup> See Appendix 6.

<sup>50</sup> *Mergers & Acquisitions Almanac*, February 2001, pp. 38.

<sup>51</sup> *Ibid.*

<sup>52</sup> *Ibid.*

<sup>53</sup> *Ibid.* U.S. firms in the oil and gas industry accounted for nearly 12 percent of year 2000 foreign acquisitions and U.S. firms in the food industry accounted for nine percent of foreign acquisitions. No other industry accounted for more than five percent of foreign acquisitions measured in dollars.

acquisitions. Foreign utilities constituted nearly 10 percent of U.S. acquisitions of foreign companies in 2000.<sup>54</sup>

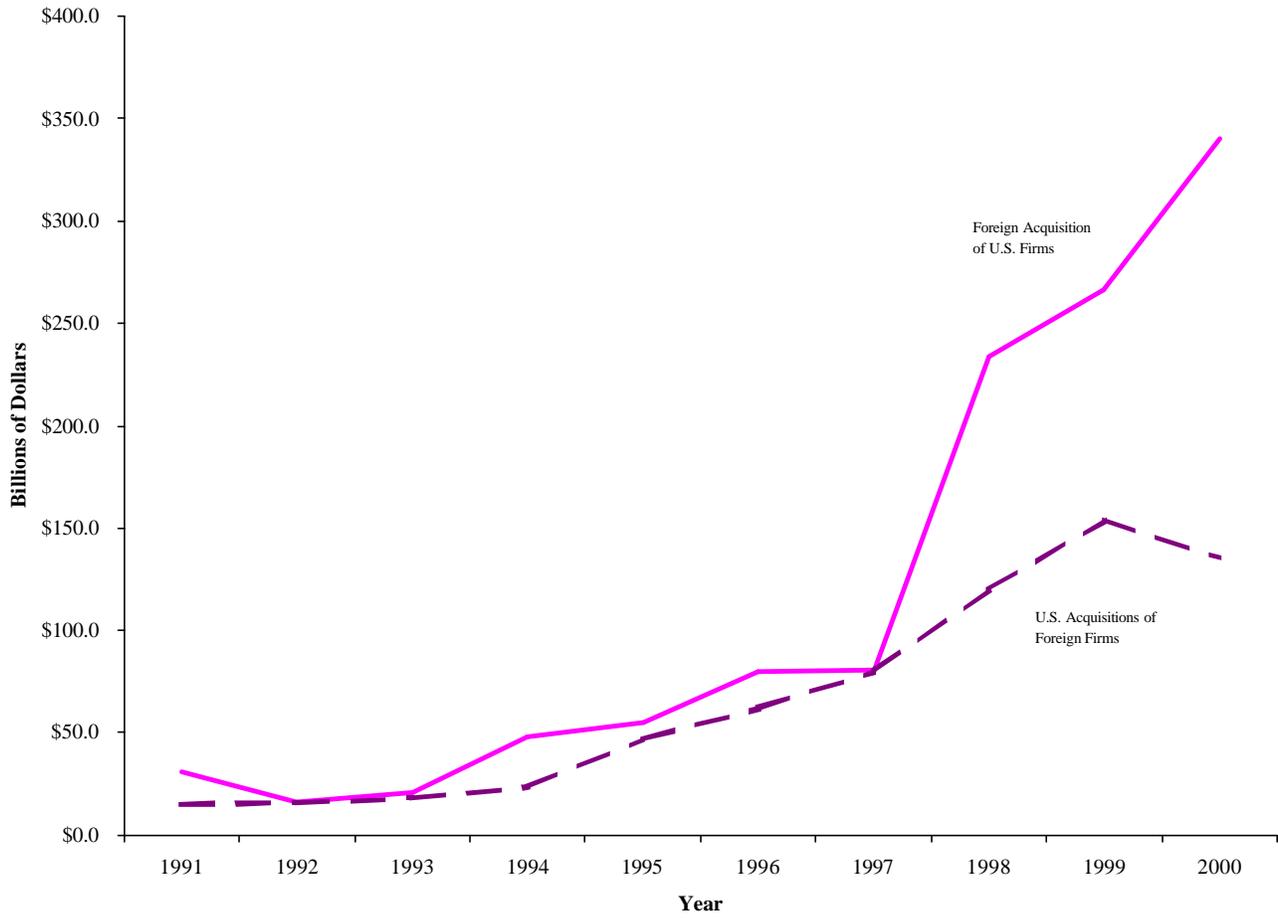
Table 2, Table 3, Table 4, and Table 5, below, list the 25 largest foreign acquisitions of U.S. companies in 2000 (Table 2) and 1999 (Table 4) and the 25 largest U.S. acquisitions of foreign companies in 2000 (Table 3) and 1999 (Table 5). The tables list the target company, the acquiring company, the domicile of the companies, the line of business of the target company, and estimated dollar value of the merger or acquisition.

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<sup>54</sup> *Ibid.* Acquisitions of foreign investment and commodity companies comprised 9.5 percent of U.S. acquisitions abroad in 2000. Acquisitions of foreign radio and television companies comprised 7.5 percent of U.S. acquisitions abroad, acquisitions of foreign business service companies comprised 6.4 percent, acquisitions of foreign metal and metal product companies comprised 6.1 percent, acquisitions of foreign oil and gas companies comprised 5.3 percent, and acquisitions of foreign electronic and electrical equipment companies comprised five percent of U.S. acquisitions abroad in 2000. No other sector accounted for more than three percent of U.S. acquisitions of foreign companies in 2000.

**Figure 30**

**Dollar Value of Cross Border Mergers and Acquisitions, 1991-2000**



Source: Mergers and Acquisitions Almanac, see Appendix 6.

**Table 2 – Top 25 Foreign Acquisitions of U.S. Companies – 2000**

<b>Acquirer</b>	<b>Domicile of Acquirer</b>	<b>Target</b>	<b>Target Industry</b>	<b>Price (\$ Billions)</b>
BP Amoco PLC	United Kingdom	Atlantic Richfield Co.	Oil and gas	\$27.2
Unilever PLC	United Kingdom	Bestfoods	Food products	25.1
UBS AG	Switzerland	PaineWebber Group Inc.	Investment banking	16.5
Credit Suisse Group	Switzerland	Donaldson, Lufkin & Jenrette Inc.	Investment banking	13.5
Cap Gemini SA	France	Consulting business of Ernst & Young LLP	Consulting services	11.8
ING Groep NV	Netherlands	Financial services and international businesses of Aetna Inc.	Insurance financial services	7.6
Nortel Networks Corp.	Canada	Alteon Websystems Inc.	Internet infrastructure products	7.1
Terra Networks SA	Spain	Lycos Inc.	Internet search engine	6.2
ING Groep NV	Netherlands	ReliaStar Financial Corp	Insurance	6.0
Nippon Telephone & Telegraph Corp.	Japan	Remaining 90% of Verio Inc.	Internet service provider	5.7
France Telecom SA	France	25% of NTL Inc.	Cable TV systems, radio stations, telecom services	5.5
PowerGen PLC	United Kingdom	LG&E Energy Corp.	Electric and gas utility	5.4
WPP Group PLC	United Kingdom	Young & Rubicam Inc.	Advertising agency	5.0
Tyco International Ltd.	Bermuda	Mallinckrodt Inc.	Diagnostic products	4.4
France Telecom SA	France	Remaining 71% of Global One Co.	Telecommunications	4.3
Sema Group PLC	United Kingdom	LHS Group Inc.	Billing and customer care services	4.3
National Grid Group PLC		New England Electric System	Electric utility; oil and gas	4.2
Stora Enso Oyj	Finland	Consolidated Papers Inc.	Paper products	4.0
BASF AG	Germany	Agricultural products business of American Home Products Corp	Crop protection products	3.9
Koninklijke Ahold NV	Netherlands	US Foodservice Inc.	Grocery products wholesaling	3.6
Rodamco North America NV	Netherlands	Urban Shopping Centers Inc.	Mall development and management	3.4
Nortel Networks Corp.	Canada	Xros Inc.	Fiber-optic network switching equipment	3.3
Nortel Networks Corp.	Canada	Otera Corp.	Fiber-optic telecommunication equipment	3.3
Cia Cementos Mexicanos SA	Mexico	Southdown Inc.	Cement; limestone mining	2.8
Global Crossing Ltd.	Bermuda	IPC Communications Inc. unit of Citigroup Inc.	Integrated communication systems and services	2.8

**Table 3 – Top 25 U.S. Acquisitions of Foreign Companies – 2000**

<b>Acquirer</b>	<b>Target</b>	<b>Domicile of Acquirer</b>	<b>Target Industry</b>	<b>Price (\$ Billions)</b>
NTL Inc.	CWC Consumer Co unit of Cable and Wireless Communications PLC	United Kingdom	Telecommunication, cable TV, and internet services	11.0
Chase Manhattan Corp.	Robert Fleming Holdings Ltd.	United Kingdom	Merchant banking	7.7
NTL Inc.	Cablecom Holding AG	Switzerland	Cable TV services	3.7
Corning Inc.	90% of the optical components and device business of Pirelli SpA	Italy	Optical network components	3.6
Callahan Associates International LLC et al	55% of the North Rhine Westphalia cable network of Deutsche Telekom AG	Germany	Telecommunication services	2.8
Ford Motor Co.	Land Rover business of BMW AG	United Kingdom	Motor vehicles	2.7
General Motors Corp.	20% of the Fiat Auto SpA unit of Fiat SpA	Italy	Automobiles	2.4
General Electric Co.	Toho Mutual Life	Japan	Insurance	2.3
Citigroup Inc.	Worldwide investment banking business of Schroders PLC	United Kingdom	Investment banking	2.2
Cisco Systems Inc.	Fiber-optic networking operations of Pirelli SpA	Italy	Fiber-optic network development	2.2
AES Corp.	Additional 80.2% of Ca La Electricidad de Caracas SACA	Venezuela	Electric utility	1.7
Nationwide Mutual Insurance Co.	Ganmore Investment Management PLC unit of Royal Bank of Scotland Group PLC	United Kingdom	Investment management services	1.6
Corning Inc.	Optical fiber, cable and related equipment businesses of Siemens AG	Germany	Fiber-optic cables	1.4
Smurfit-Stone Container Corp.	St. Laurent Paperboard Inc.	Canada	Paperboard products	1.4
Intel Corp.	Giga A/S unit of NKT Holding	Denmark	Telecommunication network components	1.3
Reliant Energy Inc.	Remaining 48% of Energieproduktiebedrijf UNA NV	Netherlands	Electric utility	1.2
Kohlberg, Kravis Roberts & Co.	Non-speciality organics operations of Laporte PLC	United Kingdom	Pigments, additives, chemical compounds	1.2
AES Corp.	Additional 35.6% of Electopaulo	Brazil	Electric utility	1.1

<b>Acquirer</b>	<b>Target</b>	<b>Domicile of Acquirer</b>	<b>Target Industry</b>	<b>Price (\$ Billions)</b>
	Metropolitana Electricidade de San Paulo SA			
Diamond Technology Partners, Inc.	Cluster Consulting	Spain	Business consulting services	1.1
General Motors Corp.	17.7% of Fuji Heavy Industries Ltd.	Japan	Motor vehicles	1.1
Microsoft Corp.	MediaOne Group Inc.'s 60% stake in Titus Communications Corp.	Japan	CableTV networks	0.9
ADC Telecommunications, Inc.	Altitun AB	Sweden	Semiconductor laser modules	0.9
Delphi Automotive Systems Corp.	Lucas Diesel Systems unit of TRW Inc.	France	Diesel fuel-injection systems	0.9
Siebel Systems Inc.	Janna Systems Inc.	Canada	Electronic systems services	0.9

**Table 4 –Top 25 Foreign Acquisitions of U.S. Companies – 1999**

<b>Acquirer</b>	<b>Domicile of Acquirer</b>	<b>Target</b>	<b>Target Industry</b>	<b>Price (\$ Billions)</b>
Merger: Vodadone Group PLC	United Kingdom	AirTouch Communications	Mobile telecom and paging services	\$60.3
Scottish Power PLC	United Kingdom	PacificCorp	Electric utility company	12.6
Aegon NV	Netherlands	TransAmerica Corp.	Insurance	10.6
Global Crossing Ltd.	Bermuda	Frontier Corp.	Telecommunications	10.1
Deutsche Bank AG	Germany	Bankers Trust New York Corp.	Bank holding company	9.1
HSBC Holdings PLC	United Kingdom	Republic New York Corp.	Bank holding company	7.7
Vivendi SA	France	United States Filter Corp.	Water and wastewater treatment systems	6.3
New Holland MV	Netherlands	Case Corp.	Farm machinery	6.3
Roche Holding AG	Switzerland	Remaining 33% of Genentech Inc.	Drugs based on DNA and gene, technology	4.8
General Electric Co. P.L.C	United Kingdom	FORE Systems Inc.	Network interfaces and LAN products	4.2
Suez Lyonnaise des Eaux-Dumez SA	France	Nalco Chemical Co.	Water treatment compounds, lubricants, chemicals	4.1
ACE Ltd.	Bermuda	U.S. and international property and casualty units of CIGNA Corp.	Insurance	3.5
Quebecor Printing Inc.	Canada	World Color Press Inc.	Printing services	2.9
Fortis AG	Belgium	American Bankers Insurance Group Inc.	Insurance	2.8
Verengigd Bezit VNU	Netherlands	Nielsen Media Research Inc.	TV audience measurement services	2.8
Koninklijke Numico NV	Netherlands	General Nutrition Cos.	Vitamin and nutrition supplement stores	2.5
Buhrmann NV	Netherlands	Corporate Express Inc.	Office supplies	2.3
General Electric Co. PLC	United Kingdom	Reltec Corp.	Telcommunication systems	2.1
Stagecoach Holdings PLC	United Kingdom	Coach USA Inc.	Motorcoach sightseeing services	1.8
Alcatel SA	France	Xylan Corp.	High-bandwidth switching systems	1.8
News Corp Ltd.	Australia	Remaining 50% of Fox/Liberty Networks	Sports TV network	1.8

<b>Acquirer</b>	<b>Domicile of Acquirer</b>	<b>Target</b>	<b>Target Industry</b>	<b>Price (\$ Billions)</b>
Kensington Acquisition Sub Inc.	Italy and Germany joint venture	Cellular Communications International	Cellular communication services	1.7
Atlas Copco AB	Sweden	Rental Service Corp.	Equipment rental services	1.6
EMAP PLC	United Kingdom	Petersen Cos.	Magazine publishing	1.5
Accor SA	France	Red Roofs Inns. Inc.	Hotels	1.1
Dyckerhoff AG	Germany	Lone Star Industries Inc.	Cement	1.1
Thyssen AG	Germany	Elevator business of Dover Corp.	Elevators	1.1

**Table 5 –Top 25 U.S. Acquisition of Foreign Companies – 1999**

<b>Acquirer</b>	<b>Target</b>	<b>Domicile of Acquirer</b>	<b>Target Industry</b>	<b>Price (\$ Billions)</b>
Wal-Mart Stores Inc.	ASDA Group PLC	United Kingdom	General-merchandise retailing	\$10.8
TRW Inc.	LucasVarity PLC	United Kingdom	Engineering services; motor vehicle equipment	6.8
General Electric Co.	Japan Leasing Corp. Ltd.	Japan	Business credit services	6.6
Ford Motor Co.	Worldwide passenger vehicle business of Volvo AB	Sweden	Automobiles, trucks, and parts	6.5
Texas Pacific Group Inc.	U.K. retailing business of Allied Domecq PLC	United Kingdom	Pubs	4.3
Ameritech Corp.	20% of Bell Canada	Canada	Telecommunications	3.4
Uniphase Corp.	JDS Fitel Inc.	Canada	Fiber-optic connectors polishing machinery	3.1
AES Corp.	National Power Drax Ltd. unit of National Power PLC	United Kingdom	Electricity generation	3.0
Huntsman Corp.	Polyurethane, titanium dioxide, and selected petrochemical businesses of Imperial Chemical Industries PLC	United Kingdom	Industrial organic chemicals	2.85
CIT Group Inc.	Newcourt Credit Group Inc.	Canada	Equipment financing and leasing services	2.7
Burlington Resources Inc.	Poco Petroleum Ltd.	Canada	Oil and gas	2.5
US West Inc.	9.02% of Global Crossing Ltd.	Bermuda	Internet and telecommunication services	2.5
Weyerhaeuser Co.	MacMillan Bloedel Ltd.	Canada	Paper, pulp products; freight transportation services	2.3
Edison International Corp.	Two power stations of PowerGen PLC	United Kingdom	Electricity-generating power stations	2.1
Du Pont Co.	Herberts Paints GmbH unit of Hoechst AG	Germany	Automobile paints; chemical preparations	1.9
NTL Inc.	Diamond Cable Communications	United Kingdom	Cable TV services	1.9
Electronic Data Systems Corp.	MCI Systemhouse Inc. unit of MCI WorldCom Inc.	Canada	Computer systems	1.7
Ford Motor Co.	Kwik-Fit Holdings PLC	United Kingdom	Auto parts and repair shops	1.6
Gannett Co. Inc.	Newsquest PLC	United Kingdom	Publish newspapers	1.4
Principal Financial Group	BT Funds Management, BT	Australia	Investment banking	1.4

<b>Acquirer</b>	<b>Target</b>	<b>Domicile of Acquirer</b>	<b>Target Industry</b>	<b>Price (\$ Billions)</b>
	Portfolio Services, BT Margin Lending, and BT Investment Banking Business units of Deutsche Bank AG		services	
Energy Partnership Group	Ikon Energy/Multinet Gas	Australia	Natural gas distribution	1.3
Tyco International Inc.	Siemens Electromechanical Components AG unit of Siemens AG	Germany	Relays and electromechanical components	1.1
Global TeleSystems Group Inc.	Esprit Telecom Group PLC	United Kingdom	Telcommunications	0.9
General Electric Co.	Heavy-duty gas turbine business of Alstom SA	Netherlands	Gas turbines	0.9
General Motors Corp.	Arriva Automotive Solutions unit of Arriva PLC	United Kingdom	Vehicle leasing; fleet management	0.8

## D. Background Data Relating to Foreign Sales Corporations

### Foreign sales corporations and U.S. exports

Data on the role of foreign sales corporations in U.S. trade is limited. Figure 31 details foreign sales corporation (“FSC”) and domestic international sales corporation (“DISC”) dividends as a percentage of the profits of all U.S. corporations. While trending upwards over the last several years, FSC profits constitute less than 1.5 percent of total corporate profits. While a relatively small part of the overall profits of U.S. corporations, sales of goods and services through FSCs may represent a substantial share of U.S. exports. Figure 32 below reports the “foreign trade gross receipts” of FSCs as a percentage of total U.S. exports of goods and services for 1987, 1992, and 1996. “Foreign trade gross receipts” represent the receipts from the sale of export property, the lease payments on qualifying export property, and payments for services related to qualifying sales and leases. In general, these data measure the receipts derived from qualified export sales.<sup>55</sup> Figure 32 reports that qualifying FSC exports comprised one third of U.S. merchandise and service exports in 1996. These data give a picture of the scope of FSCs in U.S. exports but should not be over emphasized. On one hand, these data may overstate somewhat the role of FSCs as foreign trade gross receipts include the value of marketing and sales service performed abroad which would not normally be included as an export. On the other hand, the Statistics of Income Division of the Internal Revenue Service report that not all FSC tax returns report foreign trade gross receipts<sup>56</sup> and the imputation of the missing data is likely to understate the value of foreign trade gross receipts. Another factor to consider is that approximately 90 percent of FSC returns represent FSCs related to manufacturing industries. The percentages reported in Figure 32 compare FSC sales to exports of goods and services. FSC sales of manufactured goods is likely to constitute a higher percentage of merchandise exports than the percentages reported in the figure.

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<sup>55</sup> “Foreign trade gross receipts also include payments for engineering and architectural services on foreign construction projects. In the case of a commission FSC, the foreign trade gross receipts of the related supplier are included in these data. FSCs reported \$84.3 billion in foreign trade gross receipts in 1987, \$152.3 billion in 1992, and \$185.9 billion in 1996. Cynthia Belmonte, “Foreign Sales Corporations, 1996, *SOI Bulletin*, 19, Spring 2000, pp. 87-122.

<sup>56</sup> A foreign sales corporation need not report “foreign trade gross receipts” in order to determine its tax liability.

**Figure 31**

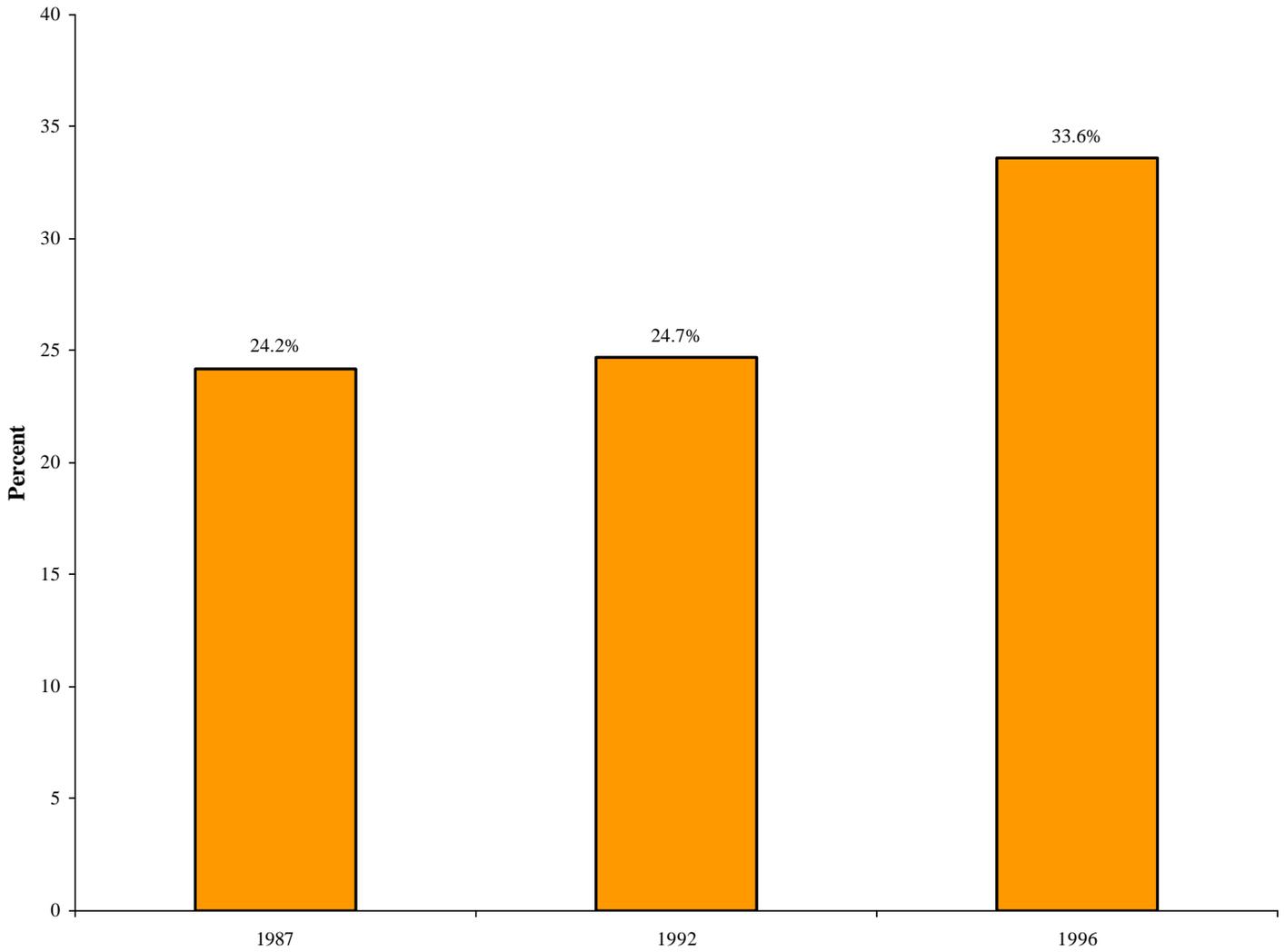
**FSC and DISC Dividends as a Percentage of Corporate Profits,  
1983-1998**



Source: Statistics of Income, Internal Revenue Service and JCT staff calculations.

**Figure 32**

**FSC Exports of Goods and Services as a Percentage of Total U.S. Exports of Goods and Services, 1987, 1992, and 1996**



Source: Statistics of Income, Internal Revenue Service and JCT staff calculations.

## Distribution of FSC Dividends Across Corporations

Among the 4.9 million corporate returns filed in 1999, 1,886 corporations (0.04 percent of corporations) reported a FSC dividend. Table 6 ranks FSC beneficiaries by decile according to the size of their FSC benefit for 1999. That is, Table 6 divides those corporations that reported FSC dividends into ten equal groups of 188 corporations, from the 188 corporations that reported the least FSC dividends to the 188 corporations that reported the most FSC dividends. Table 6 reports that among the 1,886 corporations reporting a FSC dividend in 1999, 10 percent accounted for 87 percent of the total dollar value of claimed FSC benefits. Table 6 also shows, by decile, how the average size of the FSC dividend correlates with average taxable income, average assets, and average sales.

Table 7 groups all corporate tax returns for 1999 by industry classification and shows, for each category, the number of returns on which FSC dividends were not claimed, the number of returns on which FSC dividends were claimed, and the average and total amounts of FSC dividends for each category. Table 7 shows that the manufacturing sector accounts for the bulk of the overall FSC benefit (76 percent of the number of corporations reporting FSC dividends and 89 percent of the dollar value of dividends reported in 1999). It is important to note that Table 7 is based on the industry classifications reported by the corporations themselves, using the North American Industrial Classification System (“NAICS Code”) system. These self-reported classifications are not audited or verified in any way. In addition, consolidated groups report a single classification for these purposes, which may provide a distorted view of some companies -- e.g., a large conglomerate may have lines of business in several different categories, but it would report only a single category for the entire consolidated group.

**Table 6.—All Corporations Reporting a FSC Dividend in 1999, By Decile  
(188 Firms Per Decile)**

<b>Decile by Size of FSC Dividend</b>	<b>Average FSC Dividend</b>	<b>Percentage of Total FSC Dividend</b>	<b>Average Taxable Income</b>	<b>Average Assets</b>	<b>Average Sales</b>
	<i>(thousands)</i>	<i>(percent)</i>	<i>(thousands)</i>	<i>(thousands)</i>	<i>(thousands)</i>
lowest 10 percent	\$25	0.03%	\$4,297	\$154,861	\$65,336
11 - 20th percentile	\$66	0.09%	\$2,258	\$1,000,279	\$64,793
21 - 30 <sup>th</sup> percentile	\$124	0.17%	\$5,388	\$91,434	\$107,238
31 - 40 <sup>th</sup> percentile	\$231	0.32%	\$13,755	\$204,210	\$267,977
41 - 50 <sup>th</sup> percentile	\$361	0.49%	\$9,564	\$163,106	\$167,581
51 - 60 <sup>th</sup> percentile	\$545	0.75%	\$21,155	\$587,752	\$270,579
61 - 70 <sup>th</sup> percentile	\$980	1.34%	\$81,294	\$1,495,840	\$904,679
71 - 80 <sup>th</sup> percentile	\$1,980	2.72%	\$97,506	\$7,344,215	\$1,254,670
81 - 90 <sup>th</sup> percentile	\$5,035	6.94%	\$171,370	\$4,143,671	\$2,130,158
largest 10 percent	\$63,564	87.14%	\$716,194	\$31,133,400	\$9,274,154

Source: JCT staff calculations from IRS data.

**Table 7.—Returns of Corporations Reporting FSC Dividends by Industry, 1999**

<b>Industry</b>	<b>Number of Corporations Not Claiming FSC Dividends</b>	<b>Percentage of Firms Not Claiming FSC Dividends</b>	<b>Number of Corp. Claiming FSC Dividends</b>	<b>Percentage of Firms Claiming FSC Dividends</b>	<b>Average FSC Dividend (\$ Millions)</b>	<b>Total Industry FSC Dividends (\$ Millions)</b>	<b>Percentage of Total FSC Dividends</b>
Manufacturing	296,288	6.0%	1,426	75.6%	\$8.52	\$12,156.15	88.6%
Information	107,573	2.2%	55	2.9%	\$13.58	\$746.81	5.4%
Professional, Scientific, and Technical Services	657,099	13.3%	54	2.9%	\$3.32	\$179.17	1.3%
Mining	30,829	0.6%	20	1.1%	\$7.46	\$149.18	1.1%
Wholesale Trade	349,684	7.1%	190	10.1%	\$0.71	\$135.66	1.0%
Retail Trade	596,339	12.1%	19	1.0%	\$5.87	\$111.47	0.8%
Holding Companies	43,223	0.9%	23	1.2%	\$3.16	\$72.62	0.5%
Finance and Insurance	217,766	4.4%	14	0.7%	\$4.92	\$68.92	0.5%
Agriculture, Forestry, Fishing and Hunting	141,645	2.9%	33	1.7%	\$0.91	\$30.13	0.2%
Construction	580,278	11.8%	24	1.3%	\$0.25	\$5.93	0.0%
Transportation and Warehousing	160,189	3.2%	(1)	(1)	(1)	(1)	(1)
Utilities	7,038	0.1%	(1)	(1)	(1)	(1)	(1)
Real Estate and Rental and Leasing	521,442	10.6%	(1)	(1)	(1)	(1)	(1)
Accommodation and Food Services	252,111	5.1%	(1)	(1)	(1)	(1)	(1)
Health Care and Social Services	303,498	6.2%	(1)	(1)	(1)	(1)	(1)
Other Services	305,723	6.2%	(1)	(1)	(1)	(1)	(1)
Arts, Entertainment, and Recreation	93,920	1.9%	(1)	(1)	(1)	(1)	(1)
Administrative and Support and Waste Management and Remediation Services	205,009	4.2%	(1)	(1)	(1)	(1)	(1)
Educational Services	35,195	0.7%	(1)	(1)	(1)	(1)	(1)
Wholesale and Retail Trade not Allocable	2,139	0.0%	0	0.0%	-	\$0	0.0%
Not Allocable	27,031	0.5%	0	0.0%	-	\$0	0.0%
<b>TOTAL</b>	<b>4,934,018</b>	<b>100.0%</b>	<b>1,886</b>	<b>100.0%</b>	<b>\$7.27</b>	<b>\$13,713.70</b>	<b>100.0%</b>

(1) – Data not disclosed to protect taxpayer confidentiality.

Industry classification self-reported on a consolidated return basis.

Note: Totals may not add due to rounding.

Source: JCT staff calculations from IRS data.

Because of the predominance of the manufacturing sector among those corporations reporting FSC dividends, Table 8 and Table 9 present the same information as Table 6 and Table 7 for the manufacturing sector only. Among 296,000 manufacturing corporations, 1,427 (0.48 percent) reported FSC dividends in 1999. Table 8 reports that among the 1,427 manufacturing corporations reporting a FSC dividend in 1999, 10 percent accounted for 88 percent of the total dollar value of claimed FSC benefits. Table 9 reports that three industries accounted for more than 70 percent of FSC benefits: transportation equipment (32.2 percent); computer and electronic products (25.7 percent); and chemicals (14.0 percent).

**Table 8.—All Manufacturing Corporations Reporting a FSC Dividend in 1999,  
By Decile  
(143 Firms Per Decile)**

<b>Decile by Size of FSC Dividend</b>	<b>Average FSC Dividend</b> <i>(thousands)</i>	<b>Percentage of Total FSC Dividend</b> <i>(percent)</i>	<b>Average Taxable Income</b> <i>(thousands)</i>	<b>Average Assets</b> <i>(thousands)</i>	<b>Average Sales</b> <i>(thousands)</i>
lowest 10 percent	\$29	0.04%	\$4,192	\$51,640	\$64,461
11 - 20th percentile	\$76	0.08%	\$2,522	\$82,747	\$78,378
21 - 30th percentile	\$151	0.18%	\$6,206	\$109,784	\$114,843
31 - 40th percentile	\$270	0.32%	\$6,234	\$105,024	\$120,099
41 - 50th percentile	\$390	0.46%	\$8,311	\$146,073	\$143,072
51 - 60th percentile	\$616	0.72%	\$12,680	\$374,127	\$250,463
61 - 70th percentile	\$1,089	1.28%	\$60,325	\$762,213	\$647,588
71 - 80th percentile	\$2,247	2.63%	\$57,707	\$1,751,720	\$1,123,782
81 - 90th percentile	\$5,540	6.52%	\$165,002	\$2,811,985	\$1,726,259
largest 10 percent	\$75,160	87.78%	\$687,862	\$21,892,107	\$10,191,067

Source: JCT staff calculations from IRS data.

**Table 9.—Returns of Manufacturing Corporations Reporting FSC Dividends  
Dividends by Type of Manufacturing, 1999**

Type of Manufacturing	Number of Corporations not Claiming FSC Dividends	Percentage of Firms not Claiming FSC Dividends	Number of Corporations Claiming FSC Dividends	Percentage of Firms Claiming FSC Dividends	Average FSC Dividends (\$ Millions)	Total Industry FSC Dividends (\$ Millions)	Percentage of Total FSC Dividends
Transportation Equipment	10,708	3.6%	81	5.7%	\$48.30	\$3,912.47	32.2%
Computer & Electronic Products	15,437	5.2%	288	20.2%	\$10.87	\$3,129.52	25.7%
Chemicals	10,380	3.5%	130	9.1%	\$13.08	\$1,699.80	14.0%
Machinery	25,936	8.8%	196	13.7%	\$5.20	\$1,018.24	8.4%
Electrical Equipment, Appliance, and Components	9,624	3.2%	104	7.3%	\$3.90	\$405.11	3.3%
Beverage & Tobacco	2,341	0.8%	14	1.0%	\$13.08	\$364.27	3.0%
Misc. Manufacturing	37,842	12.8%	136	9.5%	\$2.61	\$354.42	2.9%
Food	16,636	5.6%	61	4.3%	\$4.46	\$272.03	2.2%
Fabricated Metal Products	57,044	19.3%	132	9.3%	\$1.94	\$255.93	2.1%
Paper	3,089	1.0%	33	2.3%	\$7.11	\$234.47	1.9%
Primary Metals	5,191	1.8%	35	2.5%	\$3.71	\$129.92	1.1%
Plastics & Rubber Products	13,043	4.4%	60	4.2%	\$1.49	\$89.41	0.7%
Nonmetallic Mineral Products	8,627	2.9%	18	1.3%	\$4.27	\$76.82	0.6%
Textile Mills & Textile Mills Products	5,788	2.0%	38	2.7%	\$1.19	\$45.20	0.4%
Furniture & Related Products	10,966	3.7%	19	1.3%	\$1.29	\$24.60	0.2%
Wood Products	13,345	4.5%	52	3.6%	\$0.37	\$19.27	0.2%
Printing & Related Support	32,814	11.1%	10	0.7%	\$0.74	\$7.40	0.1%
Petroleum & Coal Products	1,390	0.5%	(1)	(1)	(1)	(1)	(1)
Leather & Allied Products	1,695	0.6%	(1)	(1)	(1)	(1)	(1)
Apparel	14,393	4.9%	(1)	(1)	(1)	(1)	(1)
<b>TOTAL</b>	<b>296,287</b>	<b>100.0%</b>	<b>1,427</b>	<b>100.0%</b>	<b>\$8.52</b>	<b>\$12,158.11</b>	<b>100.0%</b>

(1) – Data not disclosed to protect taxpayer confidentiality.

Industry classification self-reported on a consolidated return basis.

Note: Totals may not add due to rounding

Source: JCT staff calculations from IRS data

## Characterization of FSC beneficiaries

### In general

It is not really possible to describe a “generic” corporation that has utilized the FSC (or ETI) benefits of the Code. As detailed above, fewer than 200 corporations claimed most of the FSC benefits in 1999. These corporations generally were large when measured by assets, sales, or income. Moreover, in general, these corporations apply substantial amounts of physical (*i.e.*, plant and equipment) and intangible capital (*e.g.*, patents, trademarks, proprietary information and processes, and goodwill) in their business and also have substantial amounts of non-FSC foreign income. Yet there are numerous exceptions to this generalization of FSC beneficiaries. It also is the case that there are a number of large corporations that apply substantial amounts of physical and intangible capital in their business and also have substantial amounts of non-FSC foreign income that did not claim FSC benefits in 1999.

It is difficult to bring data to bear to characterize those corporations that claimed FSC benefits in 1999 as capital intensive or not capital intensive, to assess the extent to which such businesses earn returns from intangible capital, or to measure the extent to which FSC beneficiaries have non-FSC foreign source earnings. The source of data reported in the following tables is tax return data. These data are not perfectly suited to the task of characterizing those businesses that claim FSC benefits because items reported on the tax return may only offer crude approximations for the information necessary to describe the corporation’s business activity. For example, tax return information does not report the value of patents or copyrights that a taxpayer may be employing to earn income. Likewise tax return information does not report the value of a taxpayer’s investment in plant and equipment outside of the United States. The tables below report data drawn from the sample of corporate returns for 1999 prepared by the Internal Revenue Service’s Statistics of Income Division.

### FSC beneficiaries and investments in physical capital

Table 10 and Table 11 sort all corporations (Table 10) that reported a FSC dividend in 1999 and all manufacturing corporations (Table 11) that reported a FSC dividend in 1999 by the size of the FSC dividend reported. These tables display the average assets and average depreciation reported by decile, from those ten percent of firms reporting the smallest FSC dividends to the ten percent of firms reporting the largest FSC dividends.

**Table 10.—The Average FSC Dividend, Average Assets, and Average Depreciation  
Reported by All Corporations Reporting a FSC Dividend in 1999,  
by Decile Based on the Size of the FSC Dividend  
(188 firms per decile)**

<b>FSC Decile</b>	<b>Average FSC Dividend (\$ thousands)</b>	<b>Average Assets (\$ thousands)</b>	<b>Average Depreciation (\$ thousands)</b>
Smallest to 10 <sup>th</sup> percentile	\$25	\$154,861	\$4,505
11 <sup>th</sup> to 20 <sup>th</sup> percentile	66	1,000,279	3,648
21 <sup>st</sup> to 30 <sup>th</sup> percentile	124	91,434	3,704
31 <sup>st</sup> to 40 <sup>th</sup> percentile	231	204,210	7,227
41 <sup>st</sup> to 50 <sup>th</sup> percentile	361	163,106	4,270
51 <sup>st</sup> to 60 <sup>th</sup> percentile	545	587,572	13,172
61 <sup>st</sup> to 70 <sup>th</sup> percentile	980	1,495,840	44,758
71 <sup>st</sup> to 80 <sup>th</sup> percentile	1,980	7,344,215	44,697
81 <sup>st</sup> to 90 <sup>th</sup> percentile	5,035	4,143,671	74,333
Largest 10 percent of FSC dividends reported	63,564	31,133,400	639,211

Note: JCT staff tabulations of IRS Statistics of Income data.

**Table 11.—The Average FSC Dividend, Average Assets, and Average Depreciation  
Reported by Manufacturing Corporations Reporting a FSC Dividend in 1999,  
by Decile Based on the Size of the FSC Dividend  
(143 firms per decile)**

<b>FSC Decile</b>	<b>Average FSC Dividend (\$ thousands)</b>	<b>Average Assets (\$ thousands)</b>	<b>Average Depreciation (\$ thousands)</b>
Smallest to 10 <sup>th</sup> percentile	\$29	\$51,640	\$2,151
11 <sup>th</sup> to 20 <sup>th</sup> percentile	76	82,747	3,588
21 <sup>st</sup> to 30 <sup>th</sup> percentile	151	109,784	4,659
31 <sup>st</sup> to 40 <sup>th</sup> percentile	270	105,024	4,049
41 <sup>st</sup> to 50 <sup>th</sup> percentile	390	146,073	4,131
51 <sup>st</sup> to 60 <sup>th</sup> percentile	616	374,127	8,750
61 <sup>st</sup> to 70 <sup>th</sup> percentile	1,089	762,213	27,788
71 <sup>st</sup> to 80 <sup>th</sup> percentile	2,247	1,751,720	44,935
81 <sup>st</sup> to 90 <sup>th</sup> percentile	5,540	2,811,985	74,192
Largest 10 percent of FSC dividends reported	75,160	21,892,107	607,354

Note: JCT staff tabulations of IRS Statistics of Income data.

As reported above, manufacturing firms comprise the vast majority of FSC beneficiaries. However, obviously, not all manufacturing firms utilized an FSC. Table 12 displays, by firm size as measured by firm assets, the average depreciation reported by manufacturing firms that did not report any FSC dividends in 1999 and also displays the average depreciation reported by those manufacturing firms that did report a FSC dividend in 1999. Table 12 also reports the average FSC dividend reported by those manufacturing firms that reported a FSC dividend in 1999.

For manufacturing corporations with less than \$1 billion in assets, the average depreciation claimed in 1999 by FSC beneficiaries and by manufacturing corporations that claimed no FSC benefits was comparable. Among the largest manufacturing corporations (those with assets of \$1 billion or more), FSC beneficiaries reported nearly three times as much depreciation expense as did non-FSC beneficiaries.

**Table 12.—Number of Manufacturing Firms Not Reporting a FSC Dividend, Number of Manufacturing Firms Reporting a FSC Dividend, Average Depreciation Claimed by Manufacturing Firms Not Reporting a FSC Dividend, Average Depreciation Claimed by Manufacturing Firms Reporting a FSC Dividend, and Average FSC Dividend Reported, by Asset Size of Firm**

Size of Firm by Total Assets	Number of Firms		Average Depreciation (\$ thousands)		Average FSC Dividend (\$ thousands)
	No FSC Dividend Reported	FSC Dividend Reported	No FSC Dividend Reported	FSC Dividend Reported	
Zero or missing.....	11,665	n.d.	\$263	n.d.	n.d.
\$1 to \$999,999.....	213,029	n.d.	16	n.d.	n.d.
\$1 million to less than \$10 million.....	57,941	195	168	\$265	\$179
\$10 million to less than \$50 million.....	9,881	349	996	1,113	288
\$50 million to less than \$250 million.....	2,721	323	4,591	5,292	926
\$250 million to less than \$1 billion.....	710	234	19,811	19,007	2,619
\$1 billion or more.....	341	287	137,571	363,819	38,592
All firms.....	296,288	1,426	336	77,899	8,526

n.d. – not disclosed to protect confidentiality.

FSC beneficiaries and investments in intangible capital

As noted above, it is difficult to assess the extent to which a corporation employs intangible capital in its business activities. Two potential items reported on the corporation's tax return that are related to intangible capital are research credits claimed and royalty income earned. Table 13 and Table 14 are similar to Table 10 and Table 11 except that, instead of reporting assets and depreciation by FSC dividend decile, they report average research credit amount claimed and the average royalty income reported by FSC beneficiaries.

**Table 13.—The Average FSC Dividend, Average Research Credit Claimed, and Average Royalty Income Reported by All Corporations Reporting a FSC Dividend in 1999, by Decile Based on the Size of the FSC Dividend (188 firms per decile)**

FSC Decile	Average FSC Dividend (\$ thousands)	Average Research Credit Claimed (\$ thousands)	Average Royalty Income Reported (\$ thousands)
Smallest to 10 <sup>th</sup> percentile	\$25	\$49	\$397
11 <sup>th</sup> to 20 <sup>th</sup> percentile	66	75	125
21 <sup>st</sup> to 30 <sup>th</sup> percentile	124	62	229
31 <sup>st</sup> to 40 <sup>th</sup> percentile	231	95	2,698
41 <sup>st</sup> to 50 <sup>th</sup> percentile	361	78	936
51 <sup>st</sup> to 60 <sup>th</sup> percentile	545	161	4,081
61 <sup>st</sup> to 70 <sup>th</sup> percentile	980	393	10,579
71 <sup>st</sup> to 80 <sup>th</sup> percentile	1,980	780	16,454
81 <sup>st</sup> to 90 <sup>th</sup> percentile	5,035	1,112	19,583
Largest 10 percent of FSC dividends reported	63,564	10,505	191,518

Note: JCT staff tabulations of IRS Statistics of Income data.

**Table 14.–The Average FSC Dividend, Average Research Credit Claimed, and Average Royalty Income Reported by Manufacturing Corporations Reporting a FSC Dividend in 1999, by Decile Based on the Size of the FSC Dividend (143 firms per decile)**

<b>FSC Decile</b>	<b>Average FSC Dividend (\$ thousands)</b>	<b>Average Research Credit Claimed (\$ thousands)</b>	<b>Average Royalty Income Reported (\$ thousands)</b>
Smallest to 10 <sup>th</sup> percentile	\$29	\$75	\$604
11 <sup>th</sup> to 20 <sup>th</sup> percentile	76	35	51
21 <sup>st</sup> to 30 <sup>th</sup> percentile	151	72	372
31 <sup>st</sup> to 40 <sup>th</sup> percentile	270	67	363
41 <sup>st</sup> to 50 <sup>th</sup> percentile	390	54	763
51 <sup>st</sup> to 60 <sup>th</sup> percentile	616	121	1,950
61 <sup>st</sup> to 70 <sup>th</sup> percentile	1,089	435	10,697
71 <sup>st</sup> to 80 <sup>th</sup> percentile	2,247	814	18,831
81 <sup>st</sup> to 90 <sup>th</sup> percentile	5,540	1,269	18,838
Largest 10 percent of FSC dividends reported	75,160	12,718	214,173

Note: JCT staff tabulations of IRS Statistics of Income data.

Table 15 and Table 16 restrict the presentation to corporations that report themselves as predominantly engaged in manufacturing. Table 15 sorts manufacturing firms that did not report any FSC dividends and those that did report FSC dividends by asset size and for each size class reports the average research credit claimed in 1999. Table 16 sorts manufacturing firms that did not report any FSC dividends and those that did report FSC dividends by asset size and for each size class reports the average royalty income reported in 1999. On average, for each asset size classification, manufacturing corporations that claimed FSC benefits in 1999 claimed twice as much research credit as did manufacturing corporations that did not claim FSC benefits. Likewise, on average, for each asset size classification, manufacturing corporations that claimed FSC benefits in 1999 reported at least 50 percent more royalty income than did manufacturing corporations that did not claim FSC benefits. As reported in Table 9, three industries accounted for more than 70 percent of FSC benefits: transportation equipment; computer and electronic products; and chemicals. Given the technical nature of these industries, the indication of potentially greater reliance on intangible capital by FSC beneficiaries reported in Table 15 and Table 16 may be expected.

**Table 15.—Number of Manufacturing Firms Not Reporting a FSC Dividend, Number of Manufacturing Firms Reporting a FSC Dividend, Average Research Credit Claimed by Manufacturing Firms Not Reporting a FSC Dividend, Average Research Credit Claimed by Manufacturing Firms Reporting a FSC Dividend, and Average FSC Dividend Reported, by Asset Size of Firm**

Size of Firm by Total Assets	Number of Firms		Average Research Credit Claimed (\$ thousands)		Average FSC Dividend (\$ thousands)
	No FSC Dividend Reported	FSC Dividend Reported	No FSC Dividend Reported	FSC Dividend Reported	
Zero or missing.....	11,665	n.d.	\$4	n.d.	n.d.
\$1 to \$999,999.....	213,029	n.d.	0	n.d.	n.d.
\$1 million to less than \$10 million.....	57,941	195	2	\$12	\$179
\$10 million to less than \$50 million.....	9,881	349	15	30	288
\$50 million to less than \$250 million.....	2,721	323	64	129	926
\$250 million to less than \$1 billion.....	710	234	285	408	2,619
\$1 billion or more.....	341	287	3,057	7,220	38,592
All firms.....	296,288	1,426	6	1,561	8,526

n.d. – not disclosed to protect confidentiality.

**Table 16.—Number of Manufacturing Firms Not Reporting a FSC Dividend, Number of Manufacturing Firms Reporting a FSC Dividend, Average Royalty Income Reported by Manufacturing Firms Not Reporting a FSC Dividend, Average Royalty Income Reported by Manufacturing Firms Reporting a FSC Dividend, and Average FSC Dividend Reported, by Asset Size of Firm**

Size of Firm by Total Assets	Number of Firms		Average Royalty Income Claimed (\$ thousands)		Average FSC Dividend (\$ thousands)
	No FSC Dividend Reported	FSC Dividend Reported	No FSC Dividend Reported	FSC Dividend Reported	
Zero or missing.....	11,665	n.d.	\$64	n.d.	n.d.
\$1 to \$999,999.....	213,029	n.d.	0	n.d.	n.d.
\$1 million to less than \$10 million.....	57,941	195	1	\$2	\$179
\$10 million to less than \$50 million.....	9,881	349	23	47	288
\$50 million to less than \$250 million.....	2,721	323	301	557	926
\$250 million to less than \$1 billion.....	710	234	1,904	2,819	2,619
\$1 billion or more.....	341	287	88,858	129,051	38,592
All firms.....	296,288	1,426	6	26,576	8,526

n.d. – not disclosed to protect confidentiality.

FSC beneficiaries and other foreign operations

Corporations that claimed FSC benefits in 1999 generally were large enterprises. Many large U.S. corporations have established subsidiaries or branches overseas to increase their sales and income. Table 17 and Table 18 are similar to Table 10 and Table 11 and Table 13 and Table 14 except that they report, by decile, the average foreign tax credit claimed in 1999 and the average non-FSC foreign dividends reported in 1999 by FSC beneficiaries. These two variables reported on the corporation's tax return may serve as an indicator of the extent to which the corporation has a presence outside of the United States. As before, Table 17 presents data for all 1,885 FSC beneficiaries and Table 17 presents data for the 1,426 manufacturing firms who were FSC beneficiaries in 1999. Across all deciles of FSC beneficiaries, on average, the corporation's non-FSC foreign dividends exceed the FSC dividend reported in 1999.

**Table 17.—The Average FSC Dividend, Average Foreign Tax Credit Claimed, and Average non-FSC Foreign Dividends Reported by All Corporations Reporting a FSC Dividend in 1999, by Decile Based on the Size of the FSC Dividend (188 firms per decile)**

<b>FSC Dividend Decile</b>	<b>Average FSC Dividend (\$ thousands)</b>	<b>Average Foreign Tax Credit Claimed (\$ thousands)</b>	<b>Average Non-FSC Foreign Dividends Reported (\$ thousands)</b>
Smallest to 10 <sup>th</sup> percentile	\$25	\$48	\$33
11 <sup>th</sup> to 20 <sup>th</sup> percentile	66	231	4,519
21 <sup>st</sup> to 30 <sup>th</sup> percentile	124	125	185
31 <sup>st</sup> to 40 <sup>th</sup> percentile	231	124	278
41 <sup>st</sup> to 50 <sup>th</sup> percentile	361	160	138
51 <sup>st</sup> to 60 <sup>th</sup> percentile	545	1,912	1,616
61 <sup>st</sup> to 70 <sup>th</sup> percentile	980	5,620	12,005
71 <sup>st</sup> to 80 <sup>th</sup> percentile	1,980	10,307	6,209
81 <sup>st</sup> to 90 <sup>th</sup> percentile	5,035	12,567	32,993
Largest 10 percent of FSC dividends reported	63,564	83,609	70,226

Note: JCT staff tabulations of IRS Statistics of Income data.

**Table 18.—The Average FSC Dividend, Average Foreign Tax Credit Claimed, and Average non-FSC Foreign Dividends Reported by Manufacturing Corporations Reporting a FSC Dividend in 1999, by Decile Based on the Size of the FSC Dividend (143 firms per decile)**

<b>FSC Dividend Decile</b>	<b>Average FSC Dividend (\$ thousands)</b>	<b>Average Foreign Tax Credit Claimed (\$ thousands)</b>	<b>Average Non-FSC Foreign Dividends Reported (\$ thousands)</b>
Smallest to 10 <sup>th</sup> percentile	\$29	\$26	\$19
11 <sup>th</sup> to 20 <sup>th</sup> percentile	76	45	199
21 <sup>st</sup> to 30 <sup>th</sup> percentile	151	223	321
31 <sup>st</sup> to 40 <sup>th</sup> percentile	270	38	91
41 <sup>st</sup> to 50 <sup>th</sup> percentile	390	110	153
51 <sup>st</sup> to 60 <sup>th</sup> percentile	616	1,78	418
61 <sup>st</sup> to 70 <sup>th</sup> percentile	1,089	6,878	14,825
71 <sup>st</sup> to 80 <sup>th</sup> percentile	2,247	4,881	5,385
81 <sup>st</sup> to 90 <sup>th</sup> percentile	5,540	13,851	39,911
Largest 10 percent of FSC dividends reported	75,160	92,390	85,778

Note: JCT staff tabulations of IRS Statistics of Income data.

Table 19 and Table 20 restrict the presentation to corporations that report themselves as predominantly engaged in manufacturing. Table 19 sorts manufacturing firms that did not report any FSC dividends and those that did report FSC dividends by asset size and for each size class reports the average foreign tax credit claimed. Table 20 sorts manufacturing firms that did not report any FSC dividends and those that did report FSC dividends by asset size and for each size class reports the average non-FSC foreign dividends reported in 1999.

For manufacturing corporations with less than \$1 billion in assets, the average FSC dividend claimed in 1999 exceeded the average non-FSC foreign dividend reported by FSC beneficiaries. Among the largest manufacturing corporations (those with assets of \$1 billion or more), FSC beneficiaries reported non-FSC foreign dividends nearly twice as large as FSC dividends on average.

**Table 19.—Number of Manufacturing Firms Not Reporting a FSC Dividend, Number of Manufacturing Firms Reporting a FSC Dividend, Average Foreign Tax Credit Claimed by Manufacturing Firms Not Reporting a FSC Dividend, Average Foreign Tax Credit Claimed by Manufacturing Firms Reporting a FSC Dividend, and Average FSC Dividend Reported, by Asset Size of Firm**

Size of Firm by Total Assets	Number of Firms		Average Foreign Tax Credit Claimed (\$ thousands)		Average FSC Dividend (\$ thousands)
	No FSC Dividend Reported	FSC Dividend Reported	No FSC Dividend Reported	FSC Dividend Reported	
Zero or missing.....	11,665	n.d.	\$99	n.d.	n.d.
\$1 to \$999,999.....	213,029	n.d.	0	n.d.	n.d.
\$1 million to less than \$10 million.....	57,941	195	0	\$0	\$179
\$10 million to less than \$50 million.....	9,881	349	4	12	288
\$50 million to less than \$250 million.....	2,721	323	60	205	926
\$250 million to less than \$1 billion.....	710	234	522	1,340	2,619
\$1 billion or more.....	341	287	21,697	57,404	38,592
All firms.....	296,288	1,426	31	11,826	8,526

n.d. – not disclosed to protect confidentiality.

**Table 20.—Number of Manufacturing Firms Not Reporting a FSC Dividend, Number of Manufacturing Firms Reporting a FSC Dividend, Average non-FSC Foreign Dividend Reported by Manufacturing Firms Not Reporting a FSC Dividend, Average non-FSC Foreign Dividend Reported by Manufacturing Firms Reporting a FSC Dividend, and Average FSC Dividend Reported, by Asset Size of Firm**

Size of Firm by Total Assets	Number of Firms		Average Non-FSC Foreign Dividend Reported (\$ thousands)		Average FSC Dividend (\$ thousands)
	No FSC Dividend Reported	FSC Dividend Reported	No FSC Dividend Reported	FSC Dividend Reported	
Zero or missing.....	11,665	n.d.	\$59	n.d.	n.d.
\$1 to \$999,999.....	213,029	n.d.	0	n.d.	n.d.
\$1 million to less than \$10 million.....	57,941	195	0	\$0	\$179
\$10 million to less than \$50 million.....	9,881	349	12	20	288
\$50 million to less than \$250 million.....	2,721	323	106	359	926
\$250 million to less than \$1 billion.....	710	234	1,029	1,490	2,619
\$1 billion or more.....	341	287	25,311	68,308	38,592
All firms.....	296,288	1,426	35	14,686	8,526

n.d. – not disclosed to protect confidentiality.

### **III. SELECTED ISSUES**

#### **A. The FSC-ETI Dispute**

##### **Overview**

Like many other countries, the United States has long provided export-related benefits under its tax law. In the United States, for most of the last two decades, these benefits were provided under the FSC regime. In 2000, the European Union (“EU”) succeeded in having the FSC regime declared a prohibited export subsidy by the WTO. In response to this WTO ruling, the United States repealed the FSC rules and enacted the ETI regime under the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (the “ETI Act”). The EU immediately challenged the ETI regime in the WTO, and in January of 2002 a WTO Appellate Body held that the ETI regime also constituted a prohibited export subsidy under the relevant trade agreements.

In August 2002, a WTO arbitration panel ruled that the EU could impose trade sanctions of \$4.04 billion against U.S. exports to the EU as a countermeasure to the prohibited export subsidy provided through the ETI Act. In September 2002, the European Commission published an initial list of approximately \$12 billion worth of potentially targeted U.S. exports to EU member states. EU companies were given a 60-day consultation period to appeal the inclusion of items on the sanctions list (e.g., if they relied on a particular item as an input to production). In March 2003, EU member states approved a shortened list of U.S. exports to the EU that matched the \$4 billion retaliation amount authorized by the WTO.<sup>57</sup> The list includes more than 1,600 products listed by their eight-digit codes under the EU customs classification system.

Early statements by European Commission officials indicated that the EU would refrain from imposing sanctions against the United States as long as it was evident that progress was being made toward complying with the WTO rulings. In May 2003, EU Trade Commissioner Pascal Lamy indicated that the European Commission will review the situation this fall, and if there is no sign that compliance is forthcoming at that time, the European Commission will begin the legislative procedure for the adoption of countermeasures by January 1, 2004.

##### **Background and History of the Trade Dispute Over the FSC and ETI Regimes**

###### The “DISC” dispute and enactment of the FSC regime

Prior to the enactment of the FSC regime, the United States provided a different system of export-related tax benefits, which applied to certain export-intensive corporations known as “domestic international sales corporations” (“DISCs”).<sup>58</sup> Under this regime, DISCs were

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<sup>57</sup> *European Commission Proposed Retaliatory Duties List in World Trade Organization Dispute Over U.S. Tax Treatment for Foreign Sales Corporations*, available in BNA Daily Tax Report, April 28, 2003, G-7.

<sup>58</sup> Another export incentive in turn preceded the DISC regime -- under provisions enacted in 1962, controlled foreign corporations that qualified as “export trade corporations” were permitted to reduce their subpart F income by the amount of certain export trade income.

incorporated as domestic corporations, but DISC income was exempt from corporate income tax, and the shareholder-level tax on that income was in part deferred. Shortly after the DISC regime's enactment in 1971, certain signatories to the General Agreement on Tariffs and Trade ("GATT") challenged the regime as a prohibited export subsidy. In 1976, a GATT panel sustained these challenges, as well as U.S. challenges to certain export tax incentives provided by France, Belgium, and the Netherlands. These rulings of the panel proved controversial and remained unadopted by the relevant signatory countries for a number of years.

In 1981, without conceding that the DISC regime violated the GATT, the United States agreed to adopt the general findings of the GATT panel, subject to a 1981 GATT Council Decision (the "1981 Understanding"), which was understood to qualify those findings. The 1981 Understanding had three main components: (1) GATT signatories are not required to tax export income that is attributable to economic processes occurring outside their territorial limits; (2) "arm's length" transfer pricing principles should be observed in transactions between exporting enterprises and related foreign buyers; and (3) the GATT does not prohibit the adoption of measures to avoid the double taxation of foreign-source income.

A debate subsequently ensued as to whether the DISC regime violated the GATT, as interpreted in light of the 1981 Understanding. The European Communities ("EC") argued that the DISC regime constituted an illegal export subsidy because it provided tax benefits for export income earned within the United States. The United States defended the regime on the grounds that, as applied to exports, it merely approximated the effect of a territorial tax system of the kind commonly used by European countries, which in turn was considered acceptable under the 1981 Understanding. A majority of GATT Council members sided with the EC and urged the United States to bring the DISC regime into compliance with the GATT. In addition, the EC took steps toward seeking approval for the imposition of trade sanctions against the United States, and other signatories indicated that they would seek compensation from the United States. In late 1982, the United States made a commitment to the GATT Council to develop legislation that would address these concerns, and in early 1983, the President set forth a proposal to replace the DISC regime with a new system that was thought to be GATT-compliant (without conceding that the DISC regime was not GATT-compliant).

In 1984, the Congress enacted legislation along the general lines proposed by the President, creating the FSC regime. Unlike the DISC regime, the FSC regime provided tax benefits for export-related income earned by foreign corporations that were required to have a foreign presence and to perform export-related activities outside the United States. Transfer pricing principles were also set forth for the measurement of FSC income. In light of these features, which caused the FSC regime to emulate more closely certain aspects of an exemption-method territorial tax system, the FSC regime was thought to fall directly within the terms of the 1981 Understanding.

The FSC regime had been in existence for approximately 14 years when the EU brought a case against it in the WTO in mid-1998.

### The FSC dispute and enactment of the ETI regime

In 1999, a WTO panel agreed with the EU that the FSC regime constituted a prohibited export subsidy under the relevant WTO agreements, and in early 2000 a WTO Appellate Body upheld that finding. The rulings held that the FSC rules constituted a subsidy because under those rules the government refrained from collecting revenue that was “otherwise due”; the rulings held that this subsidy was prohibited because it was export-contingent. The EU also expressed additional objections to the FSC regime that were not addressed by the WTO -- specifically, that the FSC transfer pricing rules were not “arm’s length,” and that the FSC regime encouraged the use of tax havens.

In an effort to comply with these rulings (and to address the additional concerns raised by the EU), in late 2000 the United States repealed the FSC regime and enacted the ETI regime.

Under the ETI regime, an exclusion from gross income applies with respect to “extraterritorial income,” which is a taxpayer’s gross income attributable to “foreign trading gross receipts.” This income is eligible for the exclusion to the extent that it is “qualifying foreign trade income.” Qualifying foreign trade income is the amount of gross income that, if excluded, would result in a reduction of taxable income by the greatest of: (1) 1.2 percent of the foreign trading gross receipts derived by the taxpayer from the transaction; (2) 15 percent of the “foreign trade income” derived by the taxpayer from the transaction;<sup>59</sup> or (3) 30 percent of the “foreign sale and leasing income” derived by the taxpayer from the transaction.<sup>60</sup>

Foreign trading gross receipts are gross receipts derived from certain activities in connection with “qualifying foreign trade property” with respect to which certain economic processes take place outside of the United States. Specifically, the gross receipts must be: (1) from the sale, exchange, or other disposition of qualifying foreign trade property; (2) from the lease or rental of qualifying foreign trade property for use by the lessee outside the United States; (3) for services which are related and subsidiary to the sale, exchange, disposition, lease, or rental of qualifying foreign trade property (as described above); (4) for engineering or architectural services for construction projects located outside the United States; or (5) for the performance of certain managerial services for unrelated persons. A taxpayer may elect to treat gross receipts from a transaction as not foreign trading gross receipts. As a result of such an election, a taxpayer may use any related foreign tax credits in lieu of the exclusion.

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<sup>59</sup> “Foreign trade income” is the taxable income of the taxpayer (determined without regard to the exclusion of qualifying foreign trade income) attributable to foreign trading gross receipts.

<sup>60</sup> “Foreign sale and leasing income” is the amount of the taxpayer's foreign trade income (with respect to a transaction) that is properly allocable to activities that constitute foreign economic processes. Foreign sale and leasing income also includes foreign trade income derived by the taxpayer in connection with the lease or rental of qualifying foreign trade property for use by the lessee outside the United States.

Qualifying foreign trade property generally is property manufactured, produced, grown, or extracted within or outside the United States that is held primarily for sale, lease, or rental in the ordinary course of a trade or business for direct use, consumption, or disposition outside the United States. No more than 50 percent of the fair market value of such property can be attributable to the sum of: (1) the fair market value of articles manufactured outside the United States; and (2) the direct costs of labor performed outside the United States. With respect to property that is manufactured outside the United States, certain rules are provided to ensure consistent U.S. tax treatment with respect to manufacturers.

Even before Congress enacted the ETI regime, the EU informed the United States that it intended to challenge the regime before the WTO.

### The Appellate Body decision in the ETI dispute

#### In general

Two days after the President signed the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 into law, the EU brought its case against the ETI regime in the WTO. In August of 2001, a WTO panel (the “Panel”) held that the ETI regime constituted a prohibited export subsidy under the relevant WTO agreements,<sup>61</sup> and a WTO Appellate Body (the “Appellate Body”) later affirmed the Panel’s findings (but modified the Panel’s reasoning in part).<sup>62</sup>

The Appellate Body reviewed and upheld several findings of the Panel, including the findings that the ETI legislation: (1) involves the forgoing of revenue which is otherwise due and thus gives rise to a “financial contribution” (i.e., a subsidy); (2) includes subsidies contingent on export performance; (3) does not qualify for the exception from treatment as a prohibited export subsidy as a measure to avoid double taxation of foreign-source income; (4) is inconsistent with other U.S. trade obligations because it accords less favorable treatment to imported products as compared with like products of U.S. origin; and (5) did not fully withdraw the FSC rules that were previously found to constitute a prohibited export subsidy.<sup>63</sup>

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<sup>61</sup> United States -- Tax Treatment for “Foreign Sales Corporations” -- Recourse to Article 21.5 of the DSU by the European Communities, WT/DS108/RW, Report of the Panel, August 20, 2001.

<sup>62</sup> United States -- Tax Treatment for “Foreign Sales Corporations” -- Recourse to Article 21.5 of the DSU by the European Communities, WT/DS108/RW, Report of the Panel, as modified by the Appellate Body, January 14, 2002, adopted January 29, 2002 (the “Appellate Body Decision”).

<sup>63</sup> The Appellate Body also reviewed and upheld other findings of the Panel, including a finding that the ETI rules involve prohibited export subsidies under the Agreement on Agriculture.

## Subsidy

The Panel found that the ETI rules constitute a subsidy under the Agreement on Subsidies and Countermeasures (the “SCM Agreement”). Under that agreement, a subsidy is deemed to exist if there is a financial contribution by a government, and a benefit is thereby conferred. A financial contribution by a government exists where government revenue that is otherwise due is forgone or not collected.

The Appellate Body reviewed the Panel’s finding that the ETI rules involve the forgoing of revenue that is otherwise due and thus give rise to a financial contribution. The Appellate Body stated that the term “otherwise due” implies a comparison with a “defined, normative benchmark,” to distinguish situations where revenue forgone is “otherwise due” and situations where such revenue is not “otherwise due.” The Appellate Body further stated that the normative benchmark for the ETI rules consists of the other rules of taxation applicable to the foreign-source income of U.S. citizens and residents earned through the sale or lease of property, or through the performance of related services.

The Appellate Body stated that the United States taxes U.S. citizens and residents, in principle, on all foreign-source income, subject to permissible deductions and allowable foreign tax credits. The Appellate Body further stated that, under the ETI rules, certain extraterritorial income (i.e., “qualifying foreign trade income”) is excluded from U.S. taxation, and that taxpayers may elect to apply this exclusion or be subject to tax under the other rules applicable to such income. The Appellate Body further stated that where a taxpayer elects to apply the ETI rules, “the amount of tax paid by the taxpayer will very likely be less than the tax which the taxpayer would have paid, on that income, under the rules ‘otherwise’ applicable to foreign-source income, if the taxpayer did not elect to use the ETI measure.”<sup>64</sup> The Appellate Body concluded that “the definitive exclusion from tax of [qualifying foreign trade income], compared with the taxation of other foreign-source income, and coupled with the right of election for taxpayers to use the rules of taxation most favourable to them, means that, under the contested measure, the United States foregoes revenue on [qualifying foreign trade income] which is otherwise due.”<sup>65</sup>

## Export contingency

The Appellate Body upheld the Panel’s finding that the ETI rules include subsidies contingent on export performance. The SCM Agreement prohibits “subsidies contingent, in law or in fact, whether solely or as one of several conditions, upon export performance.” The Panel found that the ETI rules involve subsidies contingent in law upon exports in relation to property produced in the United States.

The Appellate Body concluded that the ETI rules grant a tax exemption as to certain transactions involving two different types of property: (1) property that is produced within the United States and held for use outside the United States, and (2) property that is produced

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<sup>64</sup> Appellate Body Report at 32.

<sup>65</sup> Id.

outside the United States and held for use outside the United States. The Appellate Body reasoned that the division of the ETI rules into these two separate circumstances is supported by provisions in the ETI rules themselves, each addressing a particular factual situation: specifically, certain foreign-source limitation rules that apply only to property produced in the United States and certain consistency rules that apply only to property produced outside the United States. The Appellate Body concluded that the portion of the ETI rules that provides a tax exemption for property produced in the United States and held for use outside the United States is export-contingent.<sup>66</sup>

#### Exception for measures to avoid double taxation

Under the SCM Agreement, even a subsidy that is contingent on exports is not prohibited if it is found to be a measure designed to avoid the double taxation of foreign-source income (often referred to as the “Footnote 59” exception, after its location in the SCM Agreement). The Appellate Body rejected the U.S. argument that the ETI regime qualified for the Footnote 59 exception, because it found that the regime applied not only to foreign-source income that could potentially be subjected to double taxation, but also to a broad class of U.S.-source income that faced no such threat of double taxation (e.g., income attributable to manufacturing activities in the United States).

While the Appellate Body acknowledged that countries must be given latitude to develop their own definitions of foreign-source income, it held that, at a minimum, such income must have some functional connection to a foreign country sufficient to create some possibility of taxation in that foreign country. While the ETI regime’s foreign economic processes requirement ensures that transactions qualifying for benefits under the ETI regime involve some link to activities conducted abroad, the Appellate Body held that that requirement was insufficient to ensure that all of the income generated in those transactions (and benefited by the ETI regime) possessed such a link. In particular, the Appellate Body examined the three main methods for calculating “qualifying foreign trade income” under the ETI regime and noted that, of the three methods, only the one applicable to “foreign sale and leasing income” includes any allocation rule to distinguish income connected with foreign activities from income connected with domestic activities. The other two methods employ formulas based on flat percentages (1.2 percent of “foreign trading gross receipts” or 15 percent of “foreign trade income”) and thus, in the Appellate Body’s view, do not sufficiently distinguish between foreign-source and domestic-source income in providing the ETI benefit. In addition, the foreign economic processes requirement does not apply at all to “small” taxpayers (i.e., those with \$5 million or less of “foreign trading gross receipts”), and thus, according to the Appellate Body, no effort at all is made to distinguish foreign-source and domestic-source income with respect to these taxpayers.

The Appellate Body further noted that the ETI regime is elective, and that taxpayers are allowed to choose between the ETI regime and the foreign tax credit regime generally provided under U.S. law to mitigate double taxation, making it difficult in the Appellate Body’s view to

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<sup>66</sup> The Appellate Body did not opine on the issue of whether the portion of the ETI rules that applies to property produced outside the United States and held for use outside the United States is export-contingent.

maintain that the United States designed and enacted the ETI regime with a view toward avoiding double taxation.

#### Limitation on foreign content

The Appellate Body upheld the Panel's finding that the ETI rules accord less favorable treatment to imported products as compared with like products of U.S. origin and thus violate the GATT 1994, which broadly prohibits discrimination against imports. The ETI rules require that not more than 50 percent of the fair market value of qualifying foreign trade property may be attributable to articles produced or direct labor performed outside the United States. In the Appellate Body's view, this foreign-content limitation on the ETI tax benefit constitutes discrimination against imports in violation of the GATT 1994, because taxpayers seeking ETI benefits have an incentive to use U.S. inputs instead of foreign inputs in order to ensure that they comply with the foreign-content limitation.

#### Withdrawal of FSC rules

The Appellate Body upheld the Panel's finding that the United States has not fully withdrawn the FSC rules previously found to be prohibited export subsidies. In the FSC dispute, the WTO panel recommended that the United States withdraw the FSC subsidies by October 1, 2000; the WTO Dispute Settlement Body acceded to a U.S. request to modify the time period in that dispute to expire on November 1, 2000. Although the FSC rules have been largely repealed, transition rules apply to certain existing FSCs and to certain pre-existing binding contractual arrangements involving FSCs. The Appellate Body concluded that the FSC rules were required to be fully withdrawn without delay, and that there was no basis to extend the time period for the United States to fully withdraw the FSC rules.

#### Arbitration proceedings on trade sanctions

WTO rules allow complaining countries to impose countermeasures against countries that are found to violate their WTO obligations. In this dispute, the EU requested authorization from a WTO arbitration panel to impose trade sanctions in the amount of \$4.04 billion per year against U.S. exports. The EU based this figure on estimates of the total cost to the United States of providing the subsidy, not on any estimate of actual trade harm to the EU itself. The United States argued in its submission to the arbitration panel that the EU figure was disproportionate to any possible harm to the EU itself and is therefore inappropriate, and that the maximum level of permissible sanctions in this case is \$956 million per year.

The parties filed their initial submissions on the sanctions issue in early February of 2002. In August 2002, a WTO arbitration panel ruled that the EU could impose trade sanctions of \$4.04 billion against U.S. exports to the EU as a countermeasure to the prohibited export subsidies provided by the United States through the ETI Act. In September 2002, the European Commission published an initial list of approximately \$12 billion worth of potentially targeted U.S. exports to the EU member states. EU companies were given a 60-day consultation period to appeal the inclusion of items on the sanctions list (e.g., if they relied on a particular item as an input to production). In March 2003, EU member states approved a shortened list of U.S.

exports to the EU that matched the \$4 billion retaliation amount authorized by the WTO.<sup>67</sup> The list includes more than 1,600 products listed by their eight-digit codes under the EU customs classification system.

#### Authorization of trade sanctions

In May 2003, the WTO Dispute Settlement Body granted final authorization to the EU to impose sanctions against the United States. The legislative procedure for adopting countermeasures against the United States would require an agreement of the 15 EU member states, voting by a qualified majority in the EU Council, upon recommendation by the European Commission to impose sanctions.

#### **Proposed alternatives to FSC-ETI**

##### H.R. 5095 (107<sup>th</sup> Congress)

H.R. 5095, the “American Competitiveness and Corporate Accountability Act of 2002,” was introduced by Chairman William Thomas of the House Ways and Means Committee on July 11, 2002. The bill would repeal the ETI regime and replace it with international competitiveness provisions relating to income from foreign business operations and investment. The bill includes several proposals relating to subpart F (e.g., repeal of the foreign base company sales and services income rules, look-through treatment of certain payments between related controlled foreign corporations under the foreign personal holding company rules) and the foreign tax credit (e.g., allocation of interest expense using a worldwide fungibility approach, recharacterization of overall domestic losses, reduction to three foreign tax credit baskets, extension of carryforward period for foreign tax credits).<sup>68</sup> The bill also includes provisions relating to corporate tax shelters and inversion transactions.

##### H.R. 1769

H.R. 1769, the “Job Protection Act of 2003,” was introduced by Representatives Philip Crane and Charles Rangel, the House Ways and Means Trade Subcommittee chairman and the committee’s ranking member, respectively, on April 11, 2003. The bill would repeal the ETI regime and replace it with a percentage deduction for domestic manufacturing income. The bill generally allows a corporation a deduction equal to 10 percent of its taxable income related to domestic production activities for the taxable year. However, the amount of this deduction is reduced for taxpayers with foreign production activities, in proportion to the relative value of such activities. The bill also provides transition relief to current FSC/ETI beneficiaries. The bill allows current FSC/ETI benefits to remain in effect for transactions between unrelated parties pursuant to a binding contract and allows a deduction equal to a percentage of the taxpayer’s

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<sup>67</sup> *European Commission Proposed Retaliatory Duties List in World Trade Organization Dispute Over U.S. Tax Treatment for Foreign Sales Corporations*, available in BNA Daily Tax Report, April 28, 2003, G-7.

<sup>68</sup> For a more detailed analysis of the provisions contained in H.R. 5095, see Joint Committee on Taxation, *Technical Explanation of H.R. 5095*, (JCX-78-02), July 2002.

FSC/ETI benefit accrued in 2001 (indexed for inflation). The deduction is phased out over a period of five years and does not apply to the extent that the binding contract transition relief applies to the taxpayer.

## **B. Base Erosion Through Earnings Stripping and Offshore Reinsurance Transactions**

### **Earnings stripping**

#### **Background**

A U.S. corporation with a foreign parent may reduce the U.S. tax on its U.S.-source income through the payment of deductible amounts such as interest, rents, royalties and management service fees to the foreign parent or other foreign affiliates that are not subject to U.S. tax on the receipt of such payments. These transactions are commonly referred to as “earnings stripping” transactions. Although foreign corporations generally are subject to a gross-basis U.S. tax at a flat 30-percent rate on the receipt of payments like interest, rents, royalties, and certain similar types of income derived from U.S. sources, this tax may be reduced or eliminated under an applicable income tax treaty. Consequently, U.S. corporations may use certain treaties to facilitate earnings stripping transactions without having the benefit of their deductions offset by U.S. withholding taxes.

Section 163(j) addresses earnings stripping involving interest payments, by limiting the deductibility of interest paid to certain related parties if no income tax is imposed on the interest (“disqualified interest”),<sup>69</sup> if: (1) the payor’s debt-to-equity ratio exceeds 1.5 to 1 (the so-called “safe harbor”); and (2) the payor’s net interest expense exceeds 50 percent of its “adjusted taxable income” (generally taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization, and depletion). Interest amounts disallowed under these rules can be carried forward indefinitely. In addition, excess limitation (i.e., any excess of the 50-percent limit over a company’s net interest expense for a given year) can be carried forward three years.

More generally, section 482 and the regulations thereunder require that all transactions (regardless of whether the transactions involve the payment of interest, royalties, rents, management service fees or other payments) between related parties be conducted on terms consistent with an “arm’s length” standard, and permit the Secretary of the Treasury to reallocate income and deductions among such parties if that standard is not met.

Questions regarding the efficacy of the current earnings stripping rules were raised in the course of recent public discussion and legislative activity regarding corporate “inversion” transactions. It appears that the main benefit of certain recent inversion transactions was the reduction of U.S. taxes that otherwise would be incurred on income from U.S. operations, through the use of various earnings stripping strategies.<sup>70</sup> This provided some evidence that the

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<sup>69</sup> This interest also may include interest paid to unrelated parties in certain cases in which a related party guarantees the debt.

<sup>70</sup> See, e.g., Department of the Treasury, Office of Tax Policy, *Corporate Inversion Transactions: Tax Policy Implications*, May 17, 2002, Part VII.A (“Treasury study”); Joint Committee on Taxation, *Background and Description of Present-Law Rules and Proposals Relating to Corporate Inversion Transactions* (JCX-52-02), June 5, 2002, 3-4.

earnings stripping rules were not fully achieving their intended purposes and led some to conclude that these rules needed to be strengthened.<sup>71</sup>

### Legislative proposals

#### H.R. 2

The Senate amendment to H.R. 2, the “Jobs and Growth Tax Relief Reconciliation Act of 2003” would tighten the current earnings stripping rules, but only for certain inverted corporations. With respect to such corporations, the provision would eliminate the debt-equity threshold generally applicable under section 163(j) and would reduce the 50-percent thresholds for “excess interest expense” and “excess limitation” to 25 percent.

Generally, these rules would apply to transactions in which, pursuant to a plan or a series of related transactions: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity; (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) greater than 50 percent but less than 80 percent (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50 percent ownership (i.e., the “expanded affiliated group”), does not have substantial business activities in the entity’s country of incorporation, compared to the total worldwide business activities of the expanded affiliated group. The proposal would apply to all inversion transactions meeting the above test that are completed after 1996.

In addition, the proposal would apply to a transaction in which, pursuant to a plan or a series of related transactions completed after 1996 but before March 20, 2002: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity; (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 80 percent or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50 percent ownership (i.e., the “expanded affiliated group”), does not have substantial business activities in the entity’s country of incorporation, compared to the total worldwide business activities of the expanded affiliated group. With respect to such transactions completed on or after March 20, 2002, other provisions of the bill would eliminate the benefit of the inverted structure by deeming the foreign parent to be a domestic corporation, thus rendering earnings stripping concerns irrelevant.

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<sup>71</sup> See, e.g., Department of the Treasury, *General Explanations of the Administration’s Fiscal Year 2004 Revenue Proposals*, February 2003, 104 (“Treasury explanation”) (“Under current law, opportunities are available to reduce inappropriately the U.S. tax on income earned from U.S. operations through the use of foreign related-party debt. Tightening the rules of section 163(j) is necessary to eliminate these inappropriate income-reduction opportunities.”); Treasury study, Part VII.A. (“The prevalent use of foreign related-party debt in inversion transactions is evidence that [the rules of section 163(j)] should be revisited”).

## HR 5095

H.R. 5095, the “American Competitiveness Act of 2002,” was introduced by Chairman William Thomas of the House Ways and Means Committee on July 11, 2002. H.R. 5095 would strengthen the earnings stripping provisions of section 163(j) in two ways. The first involves modifications to the existing interest disallowance rule, based on net interest expense as a percentage of adjusted taxable income. The debt-equity threshold of this rule would be eliminated, and the percentage threshold would be lowered from 50 percent to 35 percent of adjusted taxable income. Carryovers of interest disallowed under this rule would be limited to five years, and the carryover of excess limitation would be eliminated.

The proposal also would strengthen section 163(j) by adding a new interest disallowance rule, which would disallow related-party interest to the extent that the U.S. subsidiaries of a foreign parent are more highly leveraged than the overall worldwide corporate group. For purposes of applying this new test, financial corporations would be treated as a separate subgroup. Interest amounts disallowed under this new rule would not be eligible for carryover, nor would any excess limitation. The modified present-law disallowance rule and the new disallowance rule would be coordinated by providing that the rule yielding the greater amount of interest disallowed would determine the overall disallowance.

The new disallowance rule would require a series of calculations. First, the total assets of the U.S. subsidiary (or U.S. affiliated group) would be divided by the total assets of the worldwide group, yielding a fraction. Debt of the U.S. subsidiary (or U.S. affiliated group) then would be defined as “disproportionate” to the extent that such debt exceeded the product of this fraction and the total external debt of the worldwide group. To the extent that disproportionate debt is attributable to related-party debt, the interest on this debt (determined using a blended average interest rate on all related-party debt) would be disallowed. For this purpose, disproportionate debt would be attributed first to related-party debt. Thus, in the calculation, disproportionate debt would be divided by the total related-party debt of the U.S. subsidiary (or U.S. affiliated group), to yield a “disproportionate domestic related party indebtedness percentage” (not to exceed 100 percent), and then the interest disallowed under the rule would be the product of this percentage and the U.S. subsidiary's (or U.S. affiliated group's) related-party interest.<sup>72</sup>

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<sup>72</sup> For example, if a worldwide group had \$ 500 of total external debt and \$ 1,000 of total assets, for a debt-assets ratio of 50 percent, and the U.S. affiliated group had \$ 75 of total debt (\$ 45 unrelated and \$ 30 related, all at a 10 percent interest rate) and \$ 100 of total assets, for a debt-assets ratio of 75 percent, then the U.S. affiliated group would be regarded as overleveraged by 25 percentage points, or \$ 25. Using a related-party-first ordering rule, the entire \$ 2.50 of interest on this \$ 25 would be disallowed under the rule. More specifically, under the calculation provided in the new rule, the U.S. affiliated group would have  $\$ 75 - [(\$ 100 / \$ 1,000) \times \$ 500] = \$ 25$  of disproportionate debt. The disproportionate domestic related party indebtedness percentage would be  $\$ 25 / \$ 30 = 83.33$  percent. Of the U.S. affiliated group's \$ 3 of interest incurred on its \$ 30 of related-party debt, 83.33 percent of this interest, or \$ 2.50, would be disallowed. If the U.S. affiliated group's \$ 30 of related-party debt had consisted of three \$ 10 loans at interest rates of 8, 9, and 10 percent, for total related-party interest of \$ 2.70, then the

The proposal would continue the present-law rules in the case of taxable REIT subsidiaries.

The proposal generally would be effective for taxable years beginning after December 31, 2003. However, the proposal would be effective for taxable years ending after July 10, 2002, for debt incurred after that date. In addition, for taxpayers involved in certain inversion transactions completed after 1996, the proposal would be effective for taxable years ending after March 20, 2002. For purposes of applying the five-year limit on carryovers of interest disallowed under the adjusted taxable income rule, amounts carried to any taxable year beginning after December 31, 2003 would be treated as having been first disallowed for the most recent taxable year beginning on or before such date. The effective date of the elimination of excess limitation carryovers would be governed by the effective date generally applicable to the relevant debt of the taxpayer.

#### Fiscal Year 2004 Budget Proposal

The President's fiscal year 2004 budget proposal was submitted to the United States Congress on February 3, 2003. The proposal would change the earnings stripping provisions of section 163(j) by: (1) modifying the safe harbor provision; (2) reducing the adjusted taxable income threshold; (3) adding a new disallowance provision based on a comparison of domestic to worldwide indebtedness; and (4) limiting carryovers.

#### Modified safe harbor

The proposal would replace the present-law debt-to-equity safe harbor with a safe harbor based on a series of debt-to-assets ratios. Under the proposal, a safe-harbor debt amount for an interest-paying U.S. corporation would be computed by: (1) categorizing all of the corporation's assets into specified classes; (2) multiplying the asset value in each class by a stated debt-to-assets ratio for such class; and (3) totaling such amounts.<sup>73</sup> A corporation would face interest disallowance under section 163(j) only if its debt exceeded this safe harbor amount. The proposal is intended to make the safe-harbor more sensitive to the ability of different types of assets to support debt.

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amount disallowed would be 83.33 percent of \$ 2.70, or \$ 2.25 (thus effectively applying the average related-party interest rate of 9 percent to \$ 25 of disproportionate related-party debt).

<sup>73</sup> Equity investments in foreign related parties (other than investments in subsidiaries) would not be taken into account. For example, if a U.S. subsidiary of a foreign parent corporation owned some stock of the foreign parent, this stock would be disregarded for purposes of determining the U.S. subsidiary's safe-harbor amount.

### Reduced adjusted taxable income threshold

The proposal would reduce the present-law threshold of 50 percent of adjusted taxable income to 35 percent.

### Domestic-foreign indebtedness comparison

The proposal would also add a new interest disallowance rule, which disallows related-party interest to the extent that a U.S. subsidiary of a foreign parent is more highly leveraged than the overall worldwide corporate group. For purposes of applying this new test, financial corporations are treated as a separate sub-group. The amount of interest disallowed under this rule would be the amount of interest attributable to the excess U.S. indebtedness, determined by a comparison of U.S. to worldwide debt-to-assets ratios. For purposes of this rule, excess U.S. indebtedness would not be able to exceed the amount (if any) by which a corporation's U.S. indebtedness exceeds its safe-harbor debt amount. Thus, this rule would only apply to corporations that exceed the safe harbor, and only to interest attributable to such excess.

The modified present-law disallowance rule and the new disallowance rule would be coordinated by providing that the rule yielding the greater amount of interest disallowed determines the overall disallowance.

### Carryovers

The proposal would limit the carryforward of interest disallowed under the "adjusted taxable income" limitation to five years. The proposal would allow no carryover of interest disallowed under the domestic-foreign indebtedness test. The proposal would eliminate the carryover of excess limitation.

The proposal would be effective for taxable years beginning after December 31, 2003.

### Analysis

As discussed above, recent corporate inversion transactions led some to raise questions regarding the efficacy of the current earnings stripping rules. Some concluded that these rules were not achieving their intended purposes and thus needed to be strengthened.<sup>74</sup> The proposals described above generally would further limit the ability to engage in earnings stripping transactions involving the payment of interest. Some may argue that the proposals do not go far enough in combating earnings stripping, as they do not address stripping transactions involving the payment of other deductible amounts, such as royalties and management service fees.

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<sup>74</sup> See, e.g., Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals*, February 2003, 104 ("Treasury explanation") ("Under current law, opportunities are available to reduce inappropriately the U.S. tax on income earned from U.S. operations through the use of foreign related-party debt. Tightening the rules of section 163(j) is necessary to eliminate these inappropriate income-reduction opportunities."); Treasury study, Part VII.A. ("The prevalent use of foreign related-party debt in inversion transactions is evidence that [the rules of section 163(j)] should be revisited").

Others argue that there is no need to strengthen the current earnings stripping rules at all, because there is no empirical evidence of abuse outside the narrow context of inversion transactions. In addition, they argue that the recent proposals are overly broad and penalize legitimate business transactions. For example, the capital structures of multinational companies often vary by line of business and the amount of leverage the market permits. Some have argued that the proposals are not sufficiently sensitive to these differences. More broadly, some have argued that the proposals would increase the cost of U.S. direct investment for some foreign-based multinationals and thus may cause these companies to reduce such investment in the future. In addition, because income tax treaties are typically relied upon to achieve earnings stripping, some have argued that the United States should reexamine certain of its income tax treaties to determine whether reductions in withholding taxes are appropriate in light of the treaty partner's tax treatment of the foreign recipient of the relevant deductible payments. Finally, it is widely recognized that the latter two proposals would introduce considerable additional complexity into the Code.

## **Reinsurance transactions**

### Background

Under a reinsurance agreement, an insurer that has underwritten risks (the “ceding company”) transfers all or a portion of the risks to a reinsurer. In the transaction, a premium may be paid or credited to the reinsurer, and assets may be transferred to the reinsurer, on which the reinsurer earns investment income. The transfer of a risk can take several forms. For example, the entirety of the risk may be transferred, or only a portion (e.g., the portion exceeding a particular dollar amount of coverage). The ceding company may retain a residual liability to pay claims or may transfer the responsibility for claims payment to the reinsurer.

Some have expressed a concern that reinsurance transactions are being used to erode the U.S. tax base. The issue first arose when foreign-based insurance companies began acquiring U.S. affiliates that insured U.S. risks. Subsequent to these acquisitions, the U.S. companies often transferred large amounts of the gross premiums earned from insuring U.S. risks to their foreign affiliates through reinsurance transactions with their foreign affiliates. As a result of these reinsurance transactions, some U.S. insurance companies argue that they are at a competitive disadvantage relative to their foreign-based competitors.<sup>75</sup>

### U.S. taxation of domestic insurance companies

#### In general

A life insurance company is subject to tax on its life insurance company taxable income, which is its life insurance gross income reduced by life insurance deductions (sec. 801). In determining life insurance gross income, a life insurance company may deduct premiums and other consideration arising out of indemnity reinsurance from the gross amount of premiums and other consideration on insurance and annuity contracts (sec. 803(a)). Similarly, a property and casualty insurance company is subject to tax on its taxable income, which is determined as the

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<sup>75</sup> Some of these U.S. insurance companies have responded by reincorporating offshore.

sum of its underwriting income and investment income (as well as gains and other income items) (sec. 831). In determining underwriting income, a property and casualty insurance company may deduct premiums paid for reinsurance from its premiums earned (sec. 832(b)(4)).

U.S. insurance companies are taxable on their worldwide income. As in the case of other types of domestic corporations, an insurance company's income derived from operations of its foreign subsidiaries generally is subject to U.S. tax when the income is repatriated as a dividend to the domestic corporation. Until repatriation, the U.S. tax on this income generally is deferred. However, under the rules of subpart F of the Code (sections 951-964), the domestic insurance company may be taxed on a current basis in the United States with respect to certain income earned by its foreign insurance subsidiaries, generally those in which it has a greater than 10-percent interest. Such income could include premiums on reinsurance transactions and the investment income earned on premiums and reserves for the reinsured risks. Generally, a foreign insurance company may elect to be taxed as a domestic insurance company on its worldwide income (sec. 953(d)), rather than under the rules of subpart F.

#### Reinsurance transactions between related persons

In the case of a reinsurance agreement between two or more related persons, section 845 provides the Treasury Secretary with authority to allocate among the parties or recharacterize income (whether investment income, premium, or otherwise), deductions, assets, reserves, credits and any other items related to the reinsurance agreement, or make any other adjustment, in order to reflect the proper source and character of the items for each party. For this purpose, related persons are defined as in section 482. In addition, the provision also permits such allocation, recharacterization, or other adjustments in a case in which one of the parties to a reinsurance agreement is, with respect to any contract covered by the agreement, in effect an agent of another party to the agreement, or a conduit between related persons.<sup>76</sup>

#### U.S. taxation of foreign insurance companies

The United States taxes foreign corporations only on income that has a sufficient nexus to the United States. Thus, a foreign corporation is generally subject to U.S. tax only on income that is “effectively connected” with the conduct of a trade or business in the United States. Such foreign corporation’s insurance income that is “effectively connected income” generally is taxed under subchapter L in the same manner and at the same rates as the income of a U.S. insurance company. An applicable income tax treaty may limit the imposition of U.S. tax on business operations of a foreign corporation to cases in which the business is conducted through a “permanent establishment” in the United States.

In addition, foreign corporations generally are subject to a gross-basis U.S. tax at a flat 30-percent rate on the receipt of interest, dividends, rents, royalties, and certain similar types of income derived from U.S. sources, subject to certain exceptions. The tax generally is collected

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<sup>76</sup> These rules may apply may apply even if one of the related parties is not a domestic company. *See* S. Rep. No. 97-494, 97th Cong., 2d Sess. 337 (1982) (describing provisions relating to the repeal of modified coinsurance provisions).

by means of withholding by the person making the payment. This tax may be reduced or eliminated under an applicable income tax treaty.

### Reinsurance excise tax

An excise tax applies to premiums paid to foreign insurers and reinsurers covering U.S. risks (secs. 4371-4374). Under this rule, a gross-basis excise tax is imposed at the rate of one percent on reinsurance and life insurance premiums. Similarly, a tax of four percent is imposed on property and casualty insurance premiums. The excise tax does not apply to premiums that are effectively connected with the conduct of a U.S. trade or business or if an applicable income tax treaty provides an exemption from the tax. Thus, the excise tax arguably provides some protection from the erosion of the U.S. tax base through reinsurance transactions. However, the frequent exemption from the tax by treaty eliminates such protection.

### Legislative proposals

#### H.R. 2

The Senate amendment to H.R. 2, the “Jobs and Growth Tax Relief Reconciliation Act of 2003” would provide a rule clarifying the treatment of certain reinsurance transactions.<sup>77</sup> The proposal would clarify the rules of section 845, relating to the authority of the Treasury Secretary to allocate items among the parties to a reinsurance agreement, recharacterize items, or make any other adjustment, in order to reflect the proper source and character of the items for each party. The proposal would authorize such allocation, recharacterization, or other adjustment, in order to reflect the proper source, character or amount of the item. It is intended that this authority be exercised in a manner similar to the authority under section 482 of the Treasury Secretary to make adjustments between related parties. It is intended that this authority be applied in situations in which the related persons (or agents or conduits) are engaged in cross-border transactions that require allocation, recharacterization, or other adjustments in order to reflect the proper source, character or amount of the item or items.

The proposal would be effective for any risk reinsured after April 11, 2002.

#### H.R. 1755

H.R. 1755, the “Reinsurance Tax Equity Act of 2001,” was introduced by Representatives Johnson and Neal on May 8, 2001. The proposal would amend section 832(b)(4) to deny a deduction for premiums paid for direct or indirect reinsurance of U.S. risks with a “related insurer” in certain circumstances. However, under the proposal, an insurance company would generally deduct reinsurance recovered from a related insurer, when calculating its taxable income, to the extent a deduction for the premium paid for the reinsurance was disallowed as a result of the proposal. A U.S. risk would include any risk related to property in the United States, or liability arising out of the activity in, or in connection with the lives or

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<sup>77</sup> Sec. 343 of the Senate amendment to H.R. 2. The provision was not adopted in the conference agreement for H.R. 2. This proposal has been approved by the Senate Finance Committee in connection with corporate inversion legislation passed by the Committee.

health of residents of, the United States. A “related insurer” would mean a reinsurer owned or controlled directly or indirectly by the same interests (within the meaning of section 482) as the person making the premium payment.

The deduction would not be denied if: (1) the income attributable to the reinsurance to which such premium relates is includible in the gross income of such reinsurer or one or more domestic corporations or citizens or residents of the United States; or (2) the related insurer establishes to the satisfaction of the Treasury Secretary that the taxable income (as determined under section 832) attributable to the reinsurance is subject to an effective rate of income tax imposed by a foreign country greater than 20 percent of the maximum rate specified in section 11. A related insurer may elect to treat income from the reinsurance of U.S. risks, which is not otherwise includible in gross income, as income that is effectively connected with the conduct of a U.S. trade or business.

The proposal would be effective with respect to premiums paid after the House Ways and Means Committee votes to report this proposal.

#### H.R. 4192

H.R. 4192 was introduced by Representatives Johnson and Neal on April 5, 2000. Under the proposal, if a domestic person directly or indirectly reinsures a United States risk with a related foreign reinsurer, then the investment income of the domestic person would be increased each year by an amount equal to the product of (1) the average of the applicable federal mid-term rates determined under section 1274(d)(1) and (2) the sum of the reserves and liabilities related to the U.S. risks ceded to the foreign reinsurer as shown on the national statement approved by the National Association of Insurance Commissioners. A U.S. risk would include any risk related to property in the United States, or liability arising out of the activity in, or in connection with the lives or health of residents of, the United States. An insurer would be a “related foreign insurer” with respect to any domestic person if such person and foreign insurer are owned or controlled directly or indirectly by the same interest (within the meaning of section 482).

Generally, this rule would not be applicable if: (1) the foreign reinsurer retaining the reinsurance includes the income attributable to the reinsurance of the U.S. risks on its U.S. tax return either as a result of having made an election to be taxed as a domestic insurance company under section 953(d) or because such income is effectively connected with the foreign reinsurer’s U.S. trade or business; (2) the foreign reinsurer elects to file a tax return and pay tax on income from the reinsurance of U.S. risks ceded to it by related domestic persons as if such income were effectively connected to a U.S. trade or business; (3) one or more domestic corporations or U.S. individuals include the income attributable to the reinsurance of the U.S. risks ceded to the related foreign reinsurer on its tax return under subpart F; or (4) the foreign reinsurer establishes to the satisfaction of the Treasury Secretary that the taxable income (as determined under section 832) attributable to the reinsurance is subject to an effective rate of income tax imposed by a foreign country greater than 20 percent of the maximum rate specified in section 11 of the Code.

The one-percent excise tax on premiums paid to foreign reinsurers would not apply to premiums to which the proposal applies.

This proposal would apply to taxable years ending after the date of enactment of the proposal.

### **Analysis**

Some have expressed a concern that reinsurance transactions are being used to erode the U.S. tax base. Foreign-based reinsurers may not be subject to U.S. tax on either the reinsurance premiums or the investment income earned on such premiums, while the U.S. ceding company receives a deduction for reinsurance premiums paid. In contrast, a U.S.-based insurance company that reinsures a risk with a foreign affiliate may be subjected to U.S. tax with respect to both the reinsurance premiums and the investment income earned on such premiums by reason of subpart F. Thus, some have argued that, with respect to foreign-based insurance companies, reinsurance transactions between related domestic and foreign parties may be used to shift income to foreign parties, subject neither to U.S. tax nor to any significant level of foreign tax. Others argue that these reinsurance transactions are on terms equivalent to arms-length and therefore do not provide an opportunity to inappropriately erode the U.S. tax base.

Because some foreign-based reinsurers are not subject to a significant level of foreign tax on either the reinsurance premiums or the investment income earned on these premiums, some U.S.-based insurance companies have argued they are at a competitive disadvantage relative to their foreign-based competitors that are subject to a lower overall effective tax rate. Others argue that, as long as these reinsurance transactions are conducted on terms equivalent to arms-length, no unfair advantage is obtained. In addition, they may argue that the benefits of operating a reinsurance company in a jurisdiction that does not impose income tax (in contrast to the United States) are overstated, because the relevant transactions are still subject to a one-percent U.S. excise tax. However, the excise tax may be difficult to collect in certain instances involving multiple-step reinsurance transactions. Some also have argued that the principal benefit of operating an insurance company in these jurisdictions is the relative simplicity of these jurisdictions' regulatory regimes.

The proposals introduced by Representatives Johnson and Neal are limited to reinsurance transactions covering U.S. risks and between related parties. Insurance transactions covering U.S. risks arguably have a greater nexus to the United States than those transactions that do not cover U.S. risks. In addition, third-party reinsurance transactions do not provide the same opportunity to allocate income, deductions, or other items inappropriately between U.S. and foreign related persons as do related-party reinsurance transactions. Nevertheless, some have argued that these proposals inappropriately extend the United States' taxing jurisdiction, because the proposals may act as a U.S. tax on foreign insurers' foreign-source investment income. Others might assert that proposals limiting base erosion through reinsurance do nothing to remove the competitive disadvantage faced by U.S.-based insurers relative to certain foreign-based reinsurers that do not engage in reinsurance transactions with related parties with respect to U.S. risks. The proposal related to section 845 raises similar issues, although it is not limited to transactions covering U.S. risks.

## APPENDIX

### DATA ON U.S. INTERNATIONAL TRANSACTIONS

**Appendix Table 1.—U.S. International Transactions, 1960-2001**  
(\$ millions of nominal dollars)

Year	Exports of Goods Services and Income Receipts	Merchandise Adjusted Excluding Military	Services	Income Receipts on U.S. Assets Abroad	Imports of Goods Services and Income Payments	Merchandise Adjusted Excluding Military	Services	Income Payments on Foreign Assets in the U.S.	Unilateral Transfers Net
1960	30,556	19,650	6,290	4,616	23,670	14,758	7,674	1,238	4,062
1961	31,402	20,108	6,295	4,999	23,453	14,537	7,671	1,245	4,127
1962	33,340	20,781	6,941	5,618	25,676	16,260	8,092	1,324	4,277
1963	35,776	22,272	7,348	6,157	26,970	17,048	8,362	1,560	4,392
1964	40,165	25,501	7,840	6,824	29,102	18,700	8,619	1,783	4,240
1965	42,722	26,461	8,824	7,437	32,708	21,510	9,111	2,088	4,583
1966	46,454	29,310	9,616	7,528	38,468	25,493	10,494	2,481	4,955
1967	49,353	30,666	10,667	8,021	41,476	26,866	11,863	2,747	5,294
1968	54,911	33,626	11,917	9,367	48,671	32,991	12,302	3,378	5,629
1969	60,132	36,414	12,806	10,913	53,998	35,807	13,322	4,869	5,735
1970	68,387	42,469	14,171	11,748	59,901	39,866	14,520	5,515	6,156
1971	72,384	43,319	16,358	12,707	66,414	45,579	15,400	5,435	7,402
1972	81,986	49,381	17,841	14,765	79,237	55,797	16,868	6,572	8,544
1973	113,050	71,410	19,832	21,808	98,997	70,499	18,843	9,655	6,913
1974	148,484	98,306	22,591	27,587	137,274	103,811	21,379	12,084	9,249
1975	157,936	107,088	25,497	25,351	132,745	98,185	21,996	12,564	7,075
1976	172,090	114,745	27,971	29,375	162,109	124,228	24,570	13,311	5,686
1977	184,655	120,816	31,485	32,354	193,764	151,907	27,640	14,217	5,226
1978	220,516	142,075	36,353	42,088	229,870	176,002	32,189	21,680	5,788
1979	287,965	184,439	39,692	63,834	281,657	212,007	36,689	32,961	6,593
1980	344,440	224,250	47,584	72,606	333,774	249,750	41,491	42,532	8,349
1981	380,928	237,044	57,354	86,529	364,196	265,067	45,503	53,626	11,702
1982	366,983	211,157	64,079	91,747	355,975	247,642	51,749	56,583	16,544
1983	356,106	201,799	64,307	90,000	377,488	268,901	54,973	53,614	17,310
1984	399,913	219,926	71,168	108,819	473,923	332,418	67,748	73,756	20,335
1985	387,612	215,915	73,155	98,542	483,769	338,088	72,862	72,819	21,998

<b>Year</b>	<b>Exports of Goods and Services and Income Receipts</b>	<b>Merchandise Adjusted Excluding Military</b>	<b>Services</b>	<b>Income Receipts on U.S. Assets Abroad</b>	<b>Imports of Goods and Services and Income Payments</b>	<b>Merchandise Adjusted Excluding Military</b>	<b>Services</b>	<b>Income Payments on Foreign Assets in the U.S.</b>	<b>Unilateral Transfers Net</b>
1986	407,098	223,344	86,689	97,064	530,142	368,425	80,147	81,571	24,132
1987	457,053	250,208	98,661	108,184	594,443	409,765	90,787	93,891	23,265
1988	567,862	320,230	110,919	136,713	663,741	447,189	98,526	118,026	25,274
1989	648,290	359,916	127,087	161,287	721,607	477,665	02,479	141,463	26,169
1990	706,975	387,401	147,832	171,742	759,287	498,435	17,659	143,192	26,654
1991	727,557	414,083	164,261	149,214	734,563	491,020	18,459	125,084	-10,752
1992	748,603	439,631	176,916	132,056	762,105	536,528	16,476	109,101	35,013
1993	777,044	456,943	185,941	134,159	821,930	589,394	122,281	110,255	37,637
1994	869,328	502,859	201,031	165,438	949,312	668,690	131,878	148,744	38,260
1995	1,005,935	575,204	219,229	211,502	1,081,776	749,374	141,447	190,955	34,057
1996	1,077,966	612,113	240,007	225,846	1,158,822	803,113	150,850	204,859	40,081
1997	1,195,538	678,366	256,614	260,558	1,294,553	876,485	166,260	251,808	40,794
1998	1,191,932	670,416	262,278	259,238	1,364,962	917,112	182,410	265,440	44,427
1999	1,242,655	684,553	272,800	285,302	1,518,106	1,029,987	189,204	298,915	48,913
2000	1,418,568	772,210	293,492	352,866	1,809,099	1,224,417	217,024	367,658	54,136
2001	1,298,397	720,831	283,758	293,808	1,665,325	1,147,446	204,953	312,926	50,501

Source: U. S. Department of Commerce, Bureau of Economic Analysis, May 2001, and U.S. Department of Commerce, news release, "U.S. International Transactions: Fourth Quarter and Year 2001," March 14, 2002.

Note: Dollar figures in millions of current year dollars. Figures for 2001 are preliminary.

**Appendix Table 2.—U.S. Gross Domestic Product, Gross Saving, Gross Investment,  
and Net Foreign Investment, 1960-2000**  
(billions of nominal dollars)

<b>Year</b>	<b>GDP</b>	<b>Gross Saving</b>	<b>Gross Investment</b>	<b>Net foreign investment</b>
1960	527.4	110.9	110.4	3.2
1961	545.7	113.9	113.8	4.3
1962	586.5	124.6	125.3	3.9
1963	618.7	132.8	132.4	5.0
1964	664.4	143.0	144.2	7.5
1965	720.1	158.1	160.0	6.2
1966	789.3	169.1	175.6	3.9
1967	834.1	171.1	175.9	3.5
1968	911.5	183.3	187.6	1.7
1969	985.3	199.8	202.7	1.8
1970	1,039.7	194.3	201.2	4.0
1971	1,128.6	211.4	222.7	0.6
1972	1,240.4	241.6	250.3	-3.6
1973	1,385.5	294.6	302.6	8.7
1974	1,501.0	304.0	314.0	7.1
1975	1,635.2	298.4	316.1	21.4
1976	1,823.9	342.7	367.2	8.9
1977	2,031.4	398.2	419.8	-9
1978	2,295.9	481.6	502.6	-10.4
1979	2,566.4	544.9	580.6	1.4
1980	2,795.6	555.5	589.5	11.4
1981	3,131.3	666.5	684.0	6.3
1982	3,259.2	625.7	628.2	-0.2
1983	3,534.9	608.0	655.0	-32.0
1984	3,932.7	769.4	787.9	-87.0
1985	4,213.0	772.5	784.2	-110.9
1986	4,452.9	735.9	779.8	-140.6
1987	4,742.5	810.4	813.8	-152.0
1988	5,108.3	936.2	894.0	-113.2
1989	5,489.1	967.6	983.9	-86.7
1990	5,803.2	977.7	1008.2	-69.2
1991	5,986.2	1015.8	1035.4	14.9
1992	6,318.9	1007.4	1051.1	-38.7
1993	6,642.3	1039.4	1103.2	-72.9
1994	7,054.3	1155.9	1214.4	-108.3
1995	7,400.5	1257.5	1284.0	-98.0
1996	7,813.2	1349.3	1382.1	-110.7
1997	8,318.4	1502.3	1532.1	-123.1
1998	8,790.2	1654.4	1629.6	-199.1
1999	9,299.2	1717.6	1645.6	-313.2
2000	9,963.1	1825.1	1741.3	-427.9

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

**Appendix Table 3.—Increase in U.S. Assets Abroad and  
Foreign Assets in the United States, 1960-2001**  
(millions of nominal dollars)

<b>Year</b>	<b>Increase in U.S. Assets Abroad</b>	<b>Increase in Foreign Assets in U.S.</b>
1960	4,099	2,294
1961	5,538	2,705
1962	4,174	1,911
1963	7,270	3,217
1964	9,560	3,643
1965	5,716	742
1966	7,321	3,661
1967	9,757	7,379
1968	10,977	9,928
1969	11,585	12,702
1970	8,470	6,359
1971	11,758	22,970
1972	13,787	21,461
1973	22,874	18,388
1974	34,745	35,341
1975	39,703	17,170
1976	51,269	38,018
1977	34,785	53,219
1978	61,130	67,036
1979	64,915	40,852
1980	85,815	62,612
1981	113,054	86,232
1982	127,882	96,589
1983	66,373	88,694
1984	40,376	117,752
1985	44,752	146,115
1986	111,723	230,009
1987	79,296	248,634
1988	106,573	246,522
1989	175,383	224,928
1990	81,234	141,571
1991	64,388	110,808
1992	74,410	170,663
1993	200,552	282,040
1994	176,056	305,989
1995	352,376	465,684
1996	413,923	586,038
1997	487,599	759,290
1998	359,632	504,464
1999	437,067	813,744
2000	580,952	1,024,218
2001	439,563	895,459

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Note: Data for 2001 are preliminary.

**Appendix Table 4.—Selected Nongovernmental Foreign Holdings  
of U.S. Assets, Both Portfolio and Direct Investment, 1982-2000  
(billions of nominal dollars)**

<b>Year</b>	<b>U.S. Treasury Securities</b>	<b>Corporate and Other Bonds</b>	<b>Corporate Equity</b>	<b>Direct Investment</b>
1982	25,758	16,709	76,279	184,842
1984	62,121	32,421	96,056	223,538
1986	96,078	140,863	168,940	284,701
1988	100,877	191,314	200,978	401,766
1990	152,452	238,903	221,741	505,346
1992	197,739	299,287	300,160	540,270
1994	235,684	368,077	371,618	617,982
1996	502,562	588,044	611,417	745,619
1998	729,738	902,153	1,110,276	912,187
2000	639,684	1,374,259	1,589,714	1,369,505

Source: Harlan W. King, "The International Investment Position of the United States at Year end 2000," "Survey of Current Business, 81, July 2001, pp. 7-29.

Note: Direct investment at current cost.

**Appendix Table 5.—Selected United States Holdings of Foreign Assets,  
Both Portfolio and Direct Investment, 1982-2000  
(billions of nominal dollars)**

<b>Year</b>	<b>Foreign Corporate Bonds</b>	<b>Foreign Corporate Equity</b>	<b>Direct Investment</b>
1982	56,604	17,442	374,059
1984	62,810	25,994	348,342
1986	85,724	72,399	404,818
1988	104,187	128,662	513,761
1990	144,717	197,596	616,655
1992	200,817	314,266	663,830
1994	321,208	627,460	786,565
1996	465,057	1,002,928	989,810
1998	576,745	1,476,184	1,196,765
2000	577,694	1,828,810	1,445,177

Source: Harlan W. King, "The International Investment Position of the United States at Yearend 2000," Survey of Current Business, 81, July 2001, pp. 7-29.

Note: Direct investment at current cost.

**Appendix Table 6.—Cross Border Mergers and Acquisitions, 1991-2000**

<b>Year</b>	<b>Foreign Acquisitions of U.S. Companies</b>		<b>United States Acquisitions of Foreign Companies</b>	
	<b>Number of Transactions</b>	<b>Dollar Value (billions)</b>	<b>Number of Transactions</b>	<b>Dollar Value (billions)</b>
1991	539	\$30.8	482	15.3
1992	406	16.1	548	15.6
1993	394	21.0	635	18.2
1994	513	48.2	762	23.4
1995	634	55.2	1,032	46.8
1996	684	79.7	1,160	62.0
1997	837	80.9	1,401	79.8
1998	982	234.0	1,688	119.7
1999	1,151	266.5	1,617	153.8
2000	1,196	340.0	1,502	135.2

Source: Mergers and Acquisitions Almanac, February 2001, p.3